

**UNIVERSITY OF CAPE TOWN**

**FACULTY OF LAW**



**AN ANALYSIS OF THE MURABAHAH ISLAMIC FINANCE  
INSTRUMENT IN THE CONTEXT OF ARTICLE 11 OF THE  
OECD MODEL TAX CONVENTION ON INCOME AND  
CAPITAL**

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## DECLARATION

I, Waleed Sahabodien, declare that this dissertation entitled, ‘An analysis of the Murabahah Islamic Finance instrument in the context of article 11 of the OECD Model Tax Convention on Income and Capital’ is my own work, that all the sources used or quoted have been indicated and acknowledged by means of complete references, and that this dissertation was not previously submitted by me for a degree at any other university.

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Date: 19 February 2018

## ABSTRACT

Conventional banking and finance is based on interest-bearing loans or investments, or equity financing arrangements. Islamic banking and finance provides equivalent functionality to conventional finance except that the underlying arrangement is based on the trading of assets, profit and loss sharing investments or leasing arrangements.

International business and trade has evolved over time and contemporary transactions and methods of providing cross-border funding has undoubtedly become more fluid and complex in this regard. So much so that non-traditional sources of financing have become more prominent as a viable alternative where we have seen a considerable increase in their use. This is evident with the steady growth and expansion of Islamic finance within the wider umbrella of the 'Islamic Economy'. Importantly, multi-national enterprises are indeed open to diversifying their funding. This is however complimentary to the primary demand for these services from a growing global Muslim population.

Article 11 governs the taxation of cross-border debt financing where the focus is in essence on the taxing rights allocated between the source and resident state respectively. In practice it appears to be a rather settled article where very few meaningful amendments have been made since its inception. The formulation and policy is based on historical factors and an agreed upon balance established at that time. With the introduction of non-traditional financial arrangement such as Islamic finance, we now perhaps see this historical balance being somewhat disturbed. It is important to note that it is an express purpose of international tax treaties to facilitate cross-border trade and ensure the economic exchanges are as seamless as possible in respect of taxation matters.

Whether the incorporation of non-traditional financial instruments in article 11 could indeed reduce the risk of double taxation or double-non taxation remains to be seen, and it is not the objective of this paper to speculate on these aspects. Rather, this dissertation seeks to analyse the position of Islamic finance with regards to the Organisation for Economic Co-operation and Development "OECD" Model Tax Convention and whether uncertainty is created under article 11 and a 'debt-claim'.

## CONTENTS

<b>DECLARATION</b> .....	ii
<b>ABSTRACT</b> .....	iii
<b>CHAPTER ONE</b> .....	1
<b>INTRODUCTION</b> .....	1
<b>1.1 BACKGROUND TO STUDY</b> .....	1
<b>1.2 STATEMENT OF THE RESEARCH PROBLEM</b> .....	4
<b>1.4 RESEARCH QUESTIONS AND OBJECTIVES</b> .....	5
<b>1.5 RESEARCH METHOD</b> .....	6
<b>1.6 CHAPTER OUTLINE</b> .....	7
<b>CHAPTER TWO</b> .....	9
<b>ISLAMIC FINANCE IN THE CONTEXT OF CROSS-BORDER ECONOMIC TRADE AND INVESTMENT</b> .....	9
<b>2.1 INTRODUCTION</b> .....	9
<b>2.2 WHAT IS ISLAMIC FINANCE</b> .....	11
<b>2.2.1 OVERVIEW OF ISLAMIC FINANCE INSTRUMENTS</b> .....	11
<b>2.3 ISLAMIC FINANCE AND DOMESTIC TAX LAW</b> .....	13
<b>2.3.1 SELECTED COUNTRIES WITH AN ISLAMIC FINANCE TAX REGIME</b> .....	13
<b>2.4 CONCLUSION</b> .....	17
<b>CHAPTER THREE</b> .....	19
<b>MURABAHAH IN THE CONTEXT OF CONVENTIONAL FINANCE AND A DEBT-CLAIM</b> .....	19
<b>3.1 INTRODUCTION</b> .....	19
<b>3.2 COMMON FEATURES OF MURABAHAH</b> .....	19
<b>3.2.1 REQUIREMENTS OF MURABAHAH</b> .....	20
<b>3.3 A DEBT-CLAIM WITHIN CONVENTIONAL FINANCE</b> .....	22
<b>3.4 MURABAHAH IN THE CONTEXT OF CONVENTIONAL DEBT FINANCE</b> .....	24
<b>3.5 CONCLUSION</b> .....	26
<b>CHAPTER FOUR</b> .....	29
<b>ARTICLE 11 OF THE OECD MODEL IN THE CONTEXT OF ISLAMIC FINANCE</b> .....	29
<b>4.1 INTRODUCTION</b> .....	29
<b>4.2 TAXING RIGHTS UNDER ARTICLE 11 OF THE OECD MODEL</b> .....	30
<b>4.3 THE HISTORY OF ARTICLE 11 OF THE OECD MODEL</b> .....	31
<b>4.3.1 THE EARLY MODELS PRIOR TO THE OECD</b> .....	32
<b>4.3.2 THE OEEC / OECD MODEL CONVENTIONS UNTIL 1977</b> .....	35
<b>4.3.3 THE OECD MODEL CONVENTION POST 1977</b> .....	41
<b>4.4 INTEREST IN ARTICLE 11 IN THE CONTEXT OF CROSS-BORDER ISLAMIC FINANCE</b> ....	42
<b>4.4.1 OPEN DEFINITION OF INTEREST IN OECD MODEL (1963)</b> .....	45
<b>4.4.2 CLOSED DEFINITION OF INTEREST IN OECD MODEL (1977)</b> .....	46

<b>4.4.3 TREATY PRACTICE IN ARTICLE 11 OF SELECTED COUNTRIES WITH AN ISLAMIC FINANCE TAX REGIME .....</b>	<b>47</b>
<b>4.5 ISLAMIC FINANCE AND DEBT-CLAIM UNDER ARTICLE 11 .....</b>	<b>49</b>
<b>4.6 CONCLUSION.....</b>	<b>53</b>
<b>CHAPTER FIVE.....</b>	<b>55</b>
<b>ARTICLE 11 AND ARTICLE 10 IN THE CONTEXT OF ISLAMIC FINANCE .....</b>	<b>55</b>
<b>5.1 INHERENT RELATIONSHIP BETWEEN INTEREST AND DIVIDENDS .....</b>	<b>55</b>
<b>5.2 PARTICIPATION IN PROFITS AND DEBT-CLAIMS (HYBRID DEBT) .....</b>	<b>57</b>
<b>CHAPTER SIX.....</b>	<b>60</b>
<b>CONCLUSIONS AND RECOMMENDATIONS .....</b>	<b>60</b>
<b>BIBLIOGRAPHY.....</b>	<b>63</b>

## CHAPTER ONE

### INTRODUCTION

#### 1.1 BACKGROUND TO STUDY

The Islamic economy continues to develop, driven by young Muslims affirming their principles, and necessitating companies to provide products and services that satisfy their faith-based needs. Indeed, the statistics speak for themselves, with the Islamic economy estimated to have been worth \$1.9 trillion in 2015. This study will in part elaborate on the latest developments and trends from this economy but in particular focus on the Islamic finance<sup>1</sup> sector, which reportedly has around \$2 trillion in assets.<sup>2</sup> It follows that Islamic finance has gradually attracted the attention of global finance while becoming a principal driver for the economies of Muslim-majority countries.

This is most evident in the oil-rich Middle Eastern nations, where the growth in the wealth in the past few decades has been tremendous. It has empowered these countries to undergo a massive transition from ‘mere’ producers of oil to major global capital exporters. In particular, in the last 30 years, the United Arab Emirates (“UAE”) has ‘undergone a profound transformation from an impoverished region of small desert principalities to a modern state with a high standard of living’.<sup>3</sup> The UAE has capitalised on the vast revenues it has generated from oil and gas<sup>4</sup> to empower and develop the economy, and Dubai in particular has become a major regional financial centre.<sup>5</sup> Nonetheless, Islamic investors are presumed to invest only in financial products and structures that comply with Islamic law, which prohibits returns that go against these principles. Due to this substantial economic progression, the Islamic banking segment has become systemically significant globally in various regions.<sup>6</sup> Islamic finance is projected to continue to expand in response

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<sup>1</sup> The concept of Islamic or Shariah-compliant finance is based on core tenets of Islam concerning property rights, social and economic justice, wealth distribution, and governance.

<sup>2</sup> Islamic Finance current estimates are based on ThomsonReuters 2015-16 data.

<sup>3</sup> “United Arab Emirates”, The World Factbook, Central Intelligence Agency; see [www.cia.gov/library/publications/the-world-factbook/geos/ae.html](http://www.cia.gov/library/publications/the-world-factbook/geos/ae.html). Accessed on 16 January 2017.

<sup>4</sup> Id. Currently, oil and gas output amounts to approximately 30% of GDP. The reserves are estimated to last for more than another 100 years.

<sup>5</sup> UAE Federal e-Government Portal, at [www.government.ae/gov/en/biz/business/enviroen.jsp](http://www.government.ae/gov/en/biz/business/enviroen.jsp). Accessed on 22 January 2017.

<sup>6</sup> The Islamic banking sector has grown at an annual rate of about 17 percent in the period 2009–13, even allowing for the post-2008 global crisis period, Ernst and Young (2015) World Islamic Banking Competitiveness Report 2014–15.

to economic growth in countries with large and relatively unbanked Muslim populations. It is also directly fuelled by the large savings accumulated by many oil-exporting countries that are seeking to invest these funds in compliant financial products. Traditionally concentrated in Muslim majority countries in the Middle East and Asia, in recent years however, Islamic finance has expanded to other countries with smaller Muslim populations. This is due to an increasing interest in Islamic finance as an alternative to conventional finance.<sup>7</sup>

The growth of Islamic finance has also led to increased demand for the International Monetary Fund to provide policy advice and capacity building in a broad range of areas. These demands for advice will likely increase as the industry grows and its importance increases.<sup>8</sup>

Nonetheless, Islamic finance faces a number of challenges. For example, despite the efforts of standard setters, Islamic finance mainly operates under a framework developed for conventional finance. Therefore, it inherently does not fully take account of the special nature of Islamic finance.<sup>9</sup> The industry is still largely an emerging one, lacking economies of scale, and functioning in an environment where legal and tax rules, financial infrastructure, and access to financial safety nets and central bank liquidity are either absent or, if available, do not appropriately take into account the special characteristics of Islamic finance.<sup>10</sup>

Despite this, Islamic financial institutions are similar to their conventional counterparts in that they are profit-maximising and offer traditional banking services, but importantly

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<sup>7</sup> The role of Islamic finance cannot be ignored because, as stated by B. Ripoll (then the Parliamentary Secretary to the Treasury of the Australian Government) in his “Address to Amanie Australia Islamic Finance Forum” (16 Apr. 2013): “Shariah prohibition of betting or gambling means that Islamic banks can use fewer risk-hedging techniques and instruments than conventional banks. As the world learnt to its cost, the excessive use of risk-hedging instruments led to the growth of ‘toxic assets’ during the Global Financial Crisis. Importantly, the Shariah prohibition of highly speculative activities not only helps to protect the economy against abuses and distortions, but also forges a closer link between financial activity and the real economy.”

<sup>8</sup> *Islamic Finance: Opportunities, Challenges, and Policy Options*, Staff Note, International Monetary Fund, April 2015, pg. 8.

<sup>9</sup> Al-Maraj 2014. Speech at the IMF Middle East and Central Asia Department Governors’ Discussion on Islamic Finance, IMF/World Bank Annual Meetings, October 9, 2014.

<sup>10</sup> Askari, H., Z. Iqbal, and A. Mirakhor. 2010. *Globalization and Islamic Finance: Convergence, Prospects and Challenges*. Singapore: Wiley Finance; Ernst & Young. 2014. *The World Islamic Banking Competitiveness Report, 2013–14, The Transition Begins*; Islamic Financial Services Board, Islamic Development Bank, and Islamic Research and Training Institute 2010. *Islamic Finance and Global Finance Stability*.

differ in some of the principles under which they operate.<sup>11</sup> Crucial to the current discussion though, is whether non-traditional financial arrangements such as Islamic financial instruments are compatible with the interest article 11 of the OECD Model Tax Convention on Income and Capital (2014)<sup>12</sup>, or whether they indeed create confusion and uncertainty, particularly with regard to a ‘debt-claim’.

At the time of writing, the author notes that the OECD Committee on Fiscal Affairs published the 2017 update to the OECD Model Tax Convention on Income and Capital on 18 December 2017 (“OECD Model (2017)”). It does not appear that any revisions have been made to the treaty text and thus article 11 has remained unchanged in this regard. This publication is the tenth edition of the condensed version incorporating significant changes developed under the OECD/G20 project to address base erosion and profit (“BEPS”).

In the absence of a specific mention of non-traditional finance arrangements (i.e. Islamic financial instruments mentioned in the article), classification conflicts may arise. In this regard it could ostensibly also contravene the underlying purpose of the OECD Model (2017) if not appropriately addressed.

Therefore the proliferation of Islamic finance is indicative of Islamic investors’ attempts to establish or source sustainable alternatives to conventional finance. The principal Islamic finance structure considered is the murabahah. This dissertation will investigate whether the development of non-traditional financing arrangements such as Islamic finance, could possibly create challenges in a cross-border treaty context such as possible legal interpretation issues and application difficulties. In turn, this could reduce certainty from a legal point of view which may possibly lead to unresolved double taxation. This dissertation makes no confirmed assertion that double taxation or double non-taxation actually occurs under these non-traditional financial instruments, but merely explores whether an avenue could be created, as a result of the possible uncertainty fostered.

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<sup>11</sup> Patrick Imam and Kangni Kpodar, *Islamic Banking: How Has it Diffused?* International Monetary Fund (IMF), WP/10/195, August 2010, pg. 3.

<sup>12</sup> Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital (15 July 2014).

In light of the above, a significant theme therefore arises, as to whether the text of article 11 in the OECD Model (2017) (specifically the definition of interest as set out in paragraph 3) is consistent with ensuring a level playing field for cross-border Islamic finance.

## **1.2 STATEMENT OF THE RESEARCH PROBLEM**

The core research problem to be addressed will be whether the ‘interest’ definition presents challenges for Islamic finance arrangements, in the first instance. This issue will be explored by reviewing the nature and precepts of Islamic finance, with a primary focus on the murabahah and its integration into South Africa’s domestic taxation in addition to other selected countries, together with the definition of ‘interest’ under article 11, to understand the position of Islamic finance under the OECD Model (2017). This is the main issue dealt with in this dissertation. Essentially, does Islamic financial instruments reduce legal certainty under the OECD Model (2017) with respect to the application of article 11 for the purposes of a debt-claim?

The musharakah Islamic finance which has the legal construct of a partnership, also presents a different tax treaty application issue that potentially involves article 6 or possibly even article 11 of the OECD Model (2017). Given the shared contribution and joint risk sharing as typically seen in these arrangements, it is not immediately clear as to which article is appropriate where the Islamic institution receives income. Similarly, permanent establishment issues may also arise. Particularly where cross-border transactions are undertaken and the Islamic financial institution dealing with underlying property or resources situated in a foreign jurisdiction. In this regard, this tax treaty issue raised is the potential taxable presence created for the Islamic institution (i.e. murabahah with underlying product being a commodity).

Therefore despite there being a range of Islamic finance products available internationally that may also create cross-border tax issues, the scope of this study will be limited to the murabahah instrument. This dissertation will thus primarily examine Islamic finance in the context of the murabahah with respect to article 11 and a debt-claim under the OECD Model (2017). An analysis of effects of other taxes on Islamic finance, such as Value Added Tax, Employees Tax or Transfer Tax, are beyond the scope of this dissertation.

### 1.3 SIGNIFICANCE OF STUDY

Islamic finance arrangements raise a number of taxation issues in general but also specifically due to the complexity of additional layers of transactions that form part thereof. Moreover, differences in the treatment of Islamic and conventional finance, if unhindered, can create cross-border spill-overs and encourage international tax arbitrage. This study explores the potential uncertainty created by Islamic finance instruments in an international tax context that has been the subject of limited academic enquiry. Whilst the study only considers one Islamic finance instrument (murabahah), it may be of use and act as a precursor for other Islamic finance instruments to be further investigated in terms of their compatibility with other respective articles in the OECD Model (2017). In particular as more and more countries are adopting domestic legislation catering for Islamic finance arrangements, this could potentially and inadvertently create further uncertainty with regards to tax treaty application.

Should this study reveal that Islamic finance creates uncertainty with regards to article 11 under the OECD Model (2017), a subsequent progression, which falls outside the ambit of this study, would be to identify additional articles in the OECD Model (2017), which perhaps also present challenges in its clear and consistent application. In this regard, tax treaty consequences of Islamic finance relating to permanent establishment issues, income from immovable property and the general application of tax treaties, amongst others, could themselves be focussed on as areas of future research. This may be of particular concern and importance for countries wishing to attract Islamic investors. Beyond the significance of Islamic finance from a tax perspective, there is a tremendous potential to engage with the global ‘impact investing’ and ‘social investing’ markets as well as the growing socially and ethically conscious consumers.

### 1.4 RESEARCH QUESTIONS AND OBJECTIVES

The main research question is: does Islamic finance reduce legal certainty under article 11 in respect of a debt-claim.<sup>13</sup> The general features of Islamic finance and the specific aspects

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<sup>13</sup> The term “debt-claim”, however, is not defined in the OECD Model (2014). Nonetheless, a “debt” is defined as a sum of money that is owed or due to be paid because of an express agreement; a specified sum of money that one person is obligated to pay and that another has the legal right to collect or receive. A fixed and certain obligation to pay money or some other valuable thing or things, either in the present or in the future. This is according to *West's Encyclopaedia of American Law, edition 2*. (2008); <https://legal-dictionary.thefreedictionary.com/debt>. Accessed 4 December 2017.

relating to the murabahah instrument will be examined in the context, scope and history of article 11 of the OECD Model (2017) in answering this question.

Subsidiary issues that arise from the main research question include an analysis of the nature of non-traditional finance arrangements such as Islamic finance, in terms of how it is conducted, and whether its introduction has impacted the historical balance established in article 11.

The objective of the study lies in identifying a potential deficit in article 11 of the OECD Model (2017), namely that in the definition of 'interest', no consideration was given to the impact of contemporary non-traditional finance arrangements for countries that use (or wish to use) Islamic finance to stimulate cross-border investment. The deficit could stem from the possibility that Islamic finance could give rise to uncertainty with respect to article 11, and therefore inadvertently create an unwanted avenue of double taxation or non-taxation.

Nonetheless, the dissertation merely intends to consider whether Islamic finance instruments such as the murabahah pose challenges in the context of OECD Model (2017) with respect to the interest article.

## **1.5 RESEARCH METHOD**

In this dissertation, the research problem and questions are addressed through an analysis of the relevant primary and secondary sources of legislation and literature. Primary legislation include respective statutes for the domestic implementation of Islamic finance in South Africa in addition to tax regimes in countries such as Malaysia, United Kingdom, Singapore and Luxembourg. In addition to the OECD Model 2017 (including prior models) as well as the Vienna Law of Conventions (1969), generally seen as international customary law.

Furthermore, policy recommendations from international fiscal organisations such as International Monetary Fund, World Bank and various governmental taxation boards were consulted. These were read together with Islamic finance industry reports from respective jurisdictions as well as global industry bodies on the development and progress of Islamic economy in general but specifically with regard to Islamic finance.

The analysis also draws on selected secondary sources including books, foreign case law, journal articles, various OECD working papers / publications and model convention commentaries. Moreover, working papers published by scholars and international researchers were also utilised.

## **1.6 CHAPTER OUTLINE**

The first chapter lays out the background to the dissertation and gives a general preliminary outline of components such as Islamic finance and article 11 of the OECD Model (2017). It also goes further to highlight the key research questions and the significance of the study.

To provide some context from a domestic perspective and thereby gain a wider appreciation of Islamic finance, a review is conducted in chapter two of the general principles of Islamic finance, followed by a discussion on changes / features adopted by the respective domestic taxation regimes in both Muslim majority countries and non-Muslim majority countries.

The third chapter provides a deeper structural understanding of Islamic finance as regards a specific instrument in the context of article 11 of the OECD Model (2017). In addition, the concept of a debt-claim is considered further. It must be emphasised that this dissertation makes no attempt to value the additional tax potentially incurred (or possibly saved to the extent double non-taxation occurs) as a result of not obtaining treaty relief but merely seeks to critique Islamic finance and its applicability under a 'debt-claim' as set out in article 11.

Chapter four looks more closely at article 11 of the OECD Model (2017) by considering its historical formulation and the key factors contributing to its form through various work papers and policy documentation submitted by its principal stakeholders. The aim is to properly understand the intention of the drafters and their specific requirements in order to enjoy the tax treaty benefits attached to cross-border payments in the form of interest. Once this is understood, one is thereafter ostensibly able to make a more comprehensive assessment of whether uncertainty is created and an enabling environment for a classification conflict to arise.

A cursory analysis is undertaken with regards to article 10 of the OECD Model (2017) in chapter five. Specifically a high level comparative review of the dividend definition in light of article 11 and the underlying reasons for the wording included therein. Furthermore, an appreciation of the inter-connectedness of the respective articles is sought to better

understand their relative application and the extent to which hybrid debt and equity arrangements are primarily dealt with.

Lastly, the sixth and final chapter will provide concluding remarks on the analysis undertaken and whether indeed Islamic finance does create uncertainty and confusion with regards to a 'debt-claim' under article 11 of the OECD Model (2017).

## CHAPTER TWO

### ISLAMIC FINANCE IN THE CONTEXT OF CROSS-BORDER ECONOMIC TRADE AND INVESTMENT

#### 2.1 INTRODUCTION

It is widely held that international juridical double taxation has harmful effects on the international exchange of goods and services and cross-border movements of capital, technology and persons.<sup>14</sup> In recognition of the need to remove this obstacle to the development of cross-border economic relations, as well as of the importance of clarifying and standardising the fiscal situation of taxpayers who are engaged in activities across multiple countries, the OECD Model (2017) purports to settle on a uniform basis the most common problems that arise in the field of international juridical double taxation.<sup>15</sup> Furthermore, the United Nations Model Double Taxation Convention between Developed and Developing Countries 2011 (“UN Model (2011)”), has similarly been established to consider ways and means for facilitating the bilateral tax agreements between developed and developing countries. The UN Model (2011) has been widely embraced by most developing countries.<sup>16</sup>

It follows that from its inception, the OECD Model Tax Convention has required periodical review to continuously address contemporary tax issues that arise in connection with the evolution of international trade and investment in the global economy. Working Party No. 1 of the OECD's Committee on Fiscal Affairs was formed on this basis and its work resulted in periodic changes to the OECD Model Tax Convention. In this regard updates were published in 1977, 1994, 1995, 1997, 2000, 2003, 2005, 2008, 2010, 2014 and 2017.

Against this backdrop, it can be seen that although estimates of the size and growth rates of assets held internationally vary, Islamic finance has shown robust growth and increasing sophistication. It illustrates a greater acceptance of non-traditional financing arrangements and ultimately a shift away from historical methods of cross-border funding that the OECD may not have considered during their deliberations previously. While it represents a small

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<sup>14</sup> Para 1 of Introduction to OECD Model Convention (2014).

<sup>15</sup> Para 3 of Introduction to OECD Model Convention (2014).

<sup>16</sup> See Wijnen, W.F.G. and M. Magenta, “The UN Model in Practice”, 51 Bulletin for International Fiscal Documentation 12 (1997), pg. 574.

proportion of the global finance market, the Islamic finance industry did experience double-digit rates of growth annually in recent years.<sup>17</sup> Industry experts estimated that assets held under Islamic finance management doubled between 2007 and 2010 to reach around \$1 trillion.<sup>18</sup> While it has been held back by a lack of mainstream awareness, there is considerable opportunity in particular in the awqaf and crowd-funding sectors, with the Islamic finance sector expected to reach \$3.5 trillion by 2021.<sup>19</sup>

The geographical expansion of Islamic finance can also be attributed to amongst other things, a sizeable global Muslim population. The global Muslim population is expected to rise from 1.7 billion in 2014 to 2.2 billion by 2030 (26.4 percent), according to Pew Research Centre's Forum on Religion & Public Life.<sup>20</sup> The Pew study further projects the Muslim population globally to grow at about twice the rate of the non-Muslim population over the next two decades. It follows therefore that in the traditional centres of Islamic finance in the Middle East and Asia, Islamic finance activities may be accelerating at a greater pace due not only to oil liquidity but also to satisfy the needs of its burgeoning population.

Among non-Muslim businesses and investors, there also is growing interest in Islamic finance. Some consider the principles of Islamic finance to be prudent and risk mitigating, while others are looking to diversify their portfolios or to raise new sources of capital.<sup>21</sup> It follows that countries without large Muslim populations may also be interested in Islamic finance in order to attract new sources of capital or to facilitate trade and investment with Muslim-majority countries.<sup>22</sup>

Therefore many countries are revising (or have revised) their tax, legal, and regulatory frameworks to attract Islamic finance. For example, several countries that want to foster an Islamic financial market have addressed issues in their domestic taxation of Islamic

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<sup>17</sup> David Oakley, Shannon Bond, Cynthia O'Murchu, and Celve Jones, "Islamic Finance Explained," Financial Times, May 30, 2008. Jennifer Jacobs, "Special Focus: Islamic Finance Gains Ground," The Edge Malaysia, October 25, 2010.

<sup>18</sup> Reuters, "Islamic Finance Set to Cross \$1 Trillion: Moody's," The Economic Times, October 21, 2010.

<sup>19</sup> Islamic Finance current estimates are based on ThomsonReuters 2015-16 data.

<sup>20</sup> Derived from 2010 baseline and 1.5 percent growth estimated by "The Future of the Global Muslim Population report", Pew Research Forum, January 2011.

<sup>21</sup> "Islamic Banking: An Asset of Promise?" OECD Observer, No. 275, November 2009. Emmanuelle Smith, "Islamic Finance: Investment Strategy About More Than Faith," Financial Times, June 21, 2010.

<sup>22</sup> Anita Hawser, "Market Forces: Islamic Finance in Asia," Global Finance, June 2010, pg. 76.

products. The goal is “to create a level playing field with the tax treatment of equivalent conventional products”.<sup>23</sup>

## 2.2 WHAT IS ISLAMIC FINANCE

Islamic (or Sharia) law is meant to regulate all aspects of a Muslim’s way of life and is not limited to the traditional term ‘religion’. The distinguishing features of Islamic financial products and services that separate them from similar conventional products are:<sup>24</sup>

- i. “Any predetermined payment over and above the actual amount of the principal is prohibited;
- ii. the lender must share in the profits or losses arising from the enterprise for which the money was lent;
- iii. making money from money is not acceptable. Making money is good only as long as it is made through productive activities. Money, as a productive factor, does not have a prior claim on production in the form of interest. It has an ex-post claim, as a reward for the risks taken by the financier;
- iv. unnecessary risk, gambling and ignorance are prohibited; and
- v. financing should only support practices or products that are not forbidden or discouraged by Islam”.

In light of the above, the Islamic finance industry is comparatively small (with its perceived limitations) in comparison to the conventional financial system. Despite this Islamic finance offers a wide range of services (albeit with the above-mentioned conditions). In particular, banking still dominates and represented about four-fifths of total Islamic finance assets in 2013.<sup>25</sup>

### 2.2.1 OVERVIEW OF ISLAMIC FINANCE INSTRUMENTS

At first instance, in Islamic finance, the term ‘loan’ refers only to a benevolent loan, a form of financial assistance to the needy to be repaid free of charge.<sup>26</sup> Furthermore, other

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<sup>23</sup> N. (Niels) Muller, *Islamic Finance and Taxation: A Level Playing Field in Sight?* 12 *Derivs. & Fin. Instrum.* 5a/Special Issue (2010), Journals IBFD.

<sup>24</sup> Box 1. The principles of Islamic finance, *Islamic Finance and Structured Community Finance Techniques: Where the Twain can meet*. Study prepared by the UNCTAD secretariat, 29 May 2006.

<sup>25</sup> Islamic Financial Services Board (IFSB). 2013. *Islamic Financial Services Industry Stability Report*. Kuala Lumpur: IFSB.

<sup>26</sup> IMF Working Paper, African, European, and Middle East and Central Asia Departments: *An Overview of Islamic Finance*, June 2015, pg. 6.

instruments of Islamic finance are not referred to as ‘loans’ but rather as financing modes falling under one of the three classifications: Profit-and-loss sharing (“PLS”), non-PLS contracts, and fee-based products.<sup>27</sup> As such Islamic finance products are similarly contract-based and may be classified into three broad categories.<sup>28</sup>

PLS financing is closest to the spirit of Islamic finance. Compared with non-PLS financing, its core principles are of equity, participation and its actual link to real economic activities. The main PLS funding methods are:<sup>29</sup>

- i. “Musharakah is a profit-and-loss sharing partnership and the most authentic form of Islamic financing. It is a contract of joint partnership where two or more partners provide capital to finance a project or own real estate or movable assets, either on a permanent or diminishing basis; and
- ii. Mudarabah is a profit-sharing and loss-bearing contract where one party supplies funding (financier as principal) and the other provides effort and management expertise with a view to generating a profit”.

Non-PLS contracts are most common in practice and are more akin to debt-like financing structures. They are generally used to finance consumer and corporate credit, as well as asset rental and manufacturing.<sup>30</sup> Non-PLS financing instruments include murabahah, ijarah, salam, and istisna:<sup>31</sup>

- i. “Murabahah is a popular Islamic finance sale transaction mostly used in trade and asset financing;<sup>32</sup>
- ii. Ijarah is a contract of sale of the right to use an asset for a period of time. It is essentially a lease contract, whereby the lessee is entitled to use the leased asset for the entire lease period;

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<sup>27</sup> Song, I. and C. Oosthuizen, “*Islamic Banking Regulation and Supervision: Survey Results and Challenges*,” IMF Working Paper 14/220, (Washington: International Monetary Fund) (2014). A paper surveyed cross-country practices related to legal and prudential frameworks governing Islamic banking activities.

<sup>28</sup> Hussain, M., A. Shahmoradi, and R. Turk. 2014. “*Overview of Islamic Finance*,” IMF Working Paper, International Monetary Fund, Washington, DC.

<sup>29</sup> IMF Working Paper, African, European, and Middle East and Central Asia Departments: *An Overview of Islamic Finance*, June 2015, pg. 7.

<sup>30</sup> Id. pg. 8.

<sup>31</sup> These Islamic finance products are in essence similar to conventional financial contracts based on mark-up sales and leasing contracts.

<sup>32</sup> The majority of Islamic financing (70 to 80 percent) takes the form of murabahah. Demirgüç-Kunt A., L. Klapper, and D. Randall, 2013, “*Islamic Finance and Financial Inclusion*,” Policy Research Working Paper 6642, (Washington: World Bank).

- iii. Salam is a form of forward agreement where delivery occurs at a future date in exchange for spot payment. Such transactions were originally allowed to meet the financing needs of small farmers as they were unable to yield adequate returns until several periods after the initial investment; and
- iv. Istisna is a contract in which a commodity can be transacted before it comes into existence. The unique feature of Istisna is that nothing is exchanged on the spot or at the time of contracting”.

Based on the above, it is plain to see that Islamic finance encompasses various products and services which provides no shortage of options for potential Islamic investors seeking an alternative.

## **2.3 ISLAMIC FINANCE AND DOMESTIC TAX LAW**

Prior to considering the position from an international tax perspective, and for the purposes of this study, it is necessary to understand how different countries address Islamic finance arrangements that are undertaken solely within its borders (from a domestic tax perspective). To this effect, it is important to appreciate the nuances of the legal framework under which various countries operate. In this regard, whether the legal form of the transaction is considered to be decisive for tax purposes (as opposed to the substance over form approach). Should this be the case, it would likely preclude domestic law from classifying these arrangements as financing arrangements. With this in mind, specific enabling legislation was required to ensure that Islamic finance was not at a disadvantage in comparison to conventional financing from a tax perspective, for countries adopting this approach.<sup>33</sup> It follows that where additional specific legislation is enacted to provide Islamic finance arrangements (deemed) interest treatment under domestic law, it inherently demonstrates the potential legal uncertainty for the application of article 11 of the OECD Model (2017).

### **2.3.1 SELECTED COUNTRIES WITH AN ISLAMIC FINANCE TAX REGIME**

In order for some countries to appropriately facilitate (and not prejudice) Islamic finance domestically, ‘modifications’ to their tax laws have been undertaken (legal approach). In contrast, other countries accommodate Islamic finance within their existing tax framework

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<sup>33</sup> Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 – South Africa, 4.8 Islamic Financing, pg. 49.

(substance approach) and sometimes supplement with the provision of advance tax rulings and/or circulars providing general guidance. Nonetheless, under both approaches, it is generally accepted that there should be no difference in treatment of Islamic finance products similar to conventional financial products of a comparable nature. For the purposes of the dissertation, South Africa (being the primary focus) as well as Malaysia, United Kingdom, Singapore and Luxembourg have been chosen on the basis of being either Muslim majority or Muslim minority countries to demonstrate how best to attract and accommodate Islamic investors based on cultural sensitivities and existing legal framework. In this regard, it can be seen that religious issues can often cause difficulties in societies which plays a pivotal role in the manner in which the legislation is perhaps incorporated domestically.

South African law is neither a classical Roman, Roman-Dutch law nor an English common law but rather a combination of an uncodified legal system, i.e. several sources are available, namely statute laws, precedents, common law, custom and customary etc. It follows that a distinguishing feature of the South African legal system is that it is mixed because it has two formal' legal systems existing in harmony within the national legal framework. Therefore South African common law largely comprises a mixture of the Roman-Dutch variant of the civil law tradition and the English common law tradition.

With the above in mind, the introduction of legislation dealing with Islamic finance was inserted in the Taxation Laws Amendment Act, 2010 so that Islamic finance was placed on equal footing with conventional finance. In this context South Africa signalled its intention to attract substantial investments. In the legislation promulgated as section 24JA of the Income Tax Act No. 58 of 1962 (“Shariah-compliant financing”), four forms of Islamic finance were recognised, namely *mudarabah*, *murabahah*, diminishing *musharakah* and *sukuk*. To achieve the objective of tax neutrality for Islamic finance, the legislation provided a series of deeming rules that essentially treats these products similar to interest-bearing arrangements.<sup>34</sup>

It follows that the provisions relating to Sharia-compliant financing has been expressly defined in line with Islamic law terminology as contained in section 24JA(1) of the South African income tax legislation. This is despite South Africa being a Muslim minority

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<sup>34</sup> See section 24JA (2), (3) and (7) of the Income Tax Act 58 of 1962.

country and the market share of Islamic finance (with limited full service Islamic finance providers) being relatively small in comparison to conventional banking and finance. Nonetheless the adoption of specific legislation to facilitate Islamic finance in South Africa appears to be in line with the objective of becoming a regional finance centre.<sup>35</sup>

In terms of the Malaysian Income Tax Act (1967), the domestic amendment was such that it, in a combination of measures,<sup>36</sup> applied domestic rules on interest to Islamic finance arrangements. The law ensured interest treatment for income elements that were received *instead* of interest when transactions in accordance with Islamic law were entered into:<sup>37</sup>

*“Any reference in this Act to interest shall apply, mutatis mutandis, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of sharia”.*

From the above, an all-encompassing method was adopted by Malaysia. As a Muslim majority country, Malaysia amended their domestic tax law to facilitate Islamic finance with relative ease. This was enabled by utilising local Islamic knowledge to ensure certainty on ‘approved’ Islamic finance transactions. Malaysia achieved such certainty by having an Islamic law Advisory Council involved with each relevant financial regulatory authority.

This approach required far less drafting and allowed amendments to be made seamlessly to domestic tax law in order to facilitate access to Islamic finance for its majority Muslim population.

In comparison, the United Kingdom (‘UK’) adopted a somewhat more subtle approach,<sup>38</sup> directing their attention to certain arrangements and eliminating specific adverse

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<sup>35</sup> Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 – South Africa, 4.8 Islamic Financing, pg. 49.

<sup>36</sup> The Malaysian law excludes any disposal of an asset or lease pursuant to a scheme of financing approved by the financial bank as a scheme that is in accordance with the principles of sharia from the normal consequences of disposal or lease, if this disposal or lease is strictly necessary for complying with these principles (section 2(8) of the ITA). For further details, see R. Bhupalan, *An Introduction to Islamic Finance and the Malaysian Experience*, Derivatives and Financial Instruments, pp. 88-92 (May/June 2009).

<sup>37</sup> Sec. 2(7) of the Malaysian Income Tax Act.

<sup>38</sup> J. Cape, *General Ledger Framework Applicable to the Taxation of Islamic Finance*, 12 Derivatives and Financial Instruments 5a (2010). The United Kingdom introduced rules for Islamic finance in the Finance Act 2005. The UK’s alternative financing regime does not mention Islamic or sharia, etc. and is purely neutral. The arrangements that fall under the new alternative financing regime are subject to withholding tax. A listed sukuk,

consequences of their domestic law, accordingly not completely treating these arrangements the same as interest / debt-claims in the way Malaysia treats these arrangements. The UK approach does not specifically refer to Islam within their tax law, as the definitions of the transactions are entirely freestanding and the desired tax treatment is given to all transactions that fall within the definition, ignoring compliance with Islamic law. However the immediate disadvantage of the UK method was that the legal drafting took substantial time and resources because all features of the transaction were required to be described intricately with no reference to sources other than statute law (other secular states may experience similar implementation issues).

Luxembourg released a circular<sup>39</sup> dealing specifically with the murabahah and the sukuk<sup>40</sup> only. With regards to the murabahah, Luxembourg did not requalify the legal form of the arrangement (two purchases) as a debt, but only allowed the deferral for tax purposes of that part of the cost-plus remuneration that was the reward for the delay in payment.<sup>41</sup> In addition, the Luxembourg circular views the sukuk as a debt or profit sharing security and classifies it as conventional debt. It follows that the remuneration is treated as interest for the Luxembourg thin capitalization rules (similar to Malaysia).

Similarly, Singapore has sought to position itself as a global financial centre and in this regard identified a need for Islamic finance. It therefore became a full member of the Islamic Financial Services Board<sup>42</sup> and subsequently it licensed its first locally-based Islamic bank, the Islamic Bank of Asia.<sup>43</sup> In line with the aim of attracting Islamic investors, the potential for double or triple imposition of stamp duties on Islamic transactions involving the murabahah or ijarah was removed (arguably similar to the UK method where disincentives were essentially removed). The income tax treatment of

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however, should be treated as falling under the Eurobond exemption: there is no UK withholding tax on securities issued by a company listed on a stock exchange which carry a right to interest. Stamp duty land tax charges were abolished and there is no capital gain on the transfer of real estate to the SPV under a sukuk arrangement. The original owner will continue to claim capital allowances on plant and equipment.

<sup>39</sup> Circulaire du directeur des contributions L.G.-A no 55 of 12 January 2010.

<sup>40</sup> Sukuk are usually asset-based financial securities. According to the Accounting and Auditing Organisation for Islamic Financial Institutions (“AAOIFI”), sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, property right, and services. IMF Working Paper, African, European, and Middle East and Central Asia Departments: *An Overview of Islamic Finance*, June 2015, pg. 19.

<sup>41</sup> France also allows spreading the taxation over time.

<sup>42</sup> Islamic finance has its own centre for education, the International Centre for Education in Islamic Finance ([www.inceif.org/](http://www.inceif.org/)), and international standard setting authority, the Islamic Financial Services Board ([www.ifsb.org/](http://www.ifsb.org/)).

<sup>43</sup> Wright, Chris, “*Banking from a distance*”, 18(8) *Asia money* 115 (2007).

receipts from Islamic bonds were made consistent with that of conventional financial instruments.<sup>44</sup> Whilst the government also introduced further measures to harmonise the tax treatment of certain Islamic financial products.

In light of the above, it is evident that Muslim and non-Muslim majority countries have recognised the potential and thereby facilitated (by overcoming obstacles according to their internal legal framework) Islamic finance into their respective domestic tax law. Significantly, this includes the UK, as a traditional and recognised global finance hub which enacted legislation precisely formulated to accommodate Islamic finance arrangements. Interestingly, South East Asian countries also introduced legislation in this regard where there was an existing Islamic law investment pool. Nonetheless it can be seen that the rules in countries that have adopted Islamic finance transactions are not always consistent with each other. At first instance, this potentially could result in confusion and uncertainty in terms of comparability and interpretation.

## **2.4 CONCLUSION**

The policy of most governments across the world is ostensibly to encourage both inward and outward foreign investment. The natural resource-rich Middle Eastern countries have at their disposal a substantial amount of potential investment funds. This presents cross-border trade and investment opportunities for countries wishing to position themselves as attractive locations for Islamic investors who are in search of profitable yet compliant returns.

Islamic law mandates that investment returns not be in the form of interest. Rather, various specially designed multi-layered financing structures may be utilised, whose returns to the Islamic investor are in the nature of distributions, rent or trading profits. In this regard, a diverse range of countries have positioned themselves to attract this lucrative foreign investment. However, where these structures are utilised, an inadvertent disadvantage may result to the extent to which the country in which the Islamic arrangement is concluded does not cater for the tax implications thereof. Simply put, the tax disadvantage directly

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<sup>44</sup> See Secs. 43N and 13(1)(zf) of the Income Tax Act. Thus, any amount payable to an individual from an Islamic bond is exempt from the income tax unless the amount is derived by the individual through a partnership in Singapore or from carrying on a trade, business or profession. In addition, income derived from fund-management services in Singapore for non-residents is generally taxed at the concessionary rate of 10%; Deloitte Singapore, Singapore Budget Commentary 2006: Keeping you updated, at 8-20.

impacts the rate of return from the investment, and therefore the attractiveness of the country as a destination for Islamic investors.

Accordingly, several countries have (or are enacting) domestic tax legislation (or varying forms of guidance to this effect) to accommodate for the inherent conflict. In essence to remove the comparative disadvantage in the recognition of Islamic law requirements.<sup>45</sup> However, the adoption of tax regimes / legislation in respect of Islamic finance arrangements by various countries have all been in a manner which is consistent with their respective overall legal framework. Clearly this does not bode well, as no uniform set of rules governing Islamic finance arrangements exists at present from a domestic tax law perspective. It follows that potential for inconsistency and confusion are thus enabled and perhaps an opening for tax arbitrage.

Given the above, it is evident that the contemporary development and progression of Islamic finance may represent sustainable, secure and practical international trade and investment opportunities. To this end it represents cross-border exchanges that could ultimately strengthen economic relations between countries. In this regard it is apt to note that one of the stated purposes of the OECD Model (2017) is the removal of obstacles that double taxation presents to the development of economic relations between countries.<sup>46</sup>

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<sup>45</sup> As previously discussed South Africa enacted changes to their income tax legislation to accommodate Islamic finance which is contained in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010.

<sup>46</sup> Para. 1 of introduction to the OECD Model (2014).

## CHAPTER THREE

### MURABAHAH IN THE CONTEXT OF CONVENTIONAL FINANCE AND A DEBT-CLAIM

#### 3.1 INTRODUCTION

As the study has discussed so far, the prominence of Islamic finance has grown substantially over the past decade. It follows that the growing reach of Islamic finance could promise a number of possible benefits. It could be seen that Islamic finance is intrinsically protected to some degree because of its risk-sharing features. It is also argued that Islamic finance is more stable than conventional finance, because *inter alia*:<sup>47</sup>

- i. “Islamic finance involves prohibitions against speculation;
- ii. financing is asset-based and thus fully collateralised; and
- iii. is founded on strong ethical precepts”.

Nonetheless, as in conventional finance, Islamic finance can be applied to trade and to projects where financial institutions can utilise their own funds or act like an investment bank and place financing with Islamic investors. This ensuing chapter gives an overview of the key elements of Islamic finance with regards to the murabahah instrument. It has been seen as the Islamic financing structure that most resembles a ‘debt-like’ arrangement.

#### 3.2 COMMON FEATURES OF MURABAHAH

The murabahah is generally seen as the most widely used instrument. It accounts for more than half of all the financing provided by Islamic financing institutions.<sup>48</sup> The root of the word “murabahah” is derived from the Arabic language, meaning “sale”.<sup>49</sup> It therefore begs the question as to the underlying reason for its popularity as a finance method considering the meaning. Nonetheless, Islamic financial institutions, using the murabahah instrument, provide their customers with financing by buying goods that their customers need, and then selling in return to their customers on a deferred payment basis. Therefore,

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<sup>47</sup> *Islamic Finance: Opportunities, Challenges, and Policy Options*, IMF Staff Discussion Note, April 2015, pg. 8.

<sup>48</sup> *Islamic Finance and Structured Community Finance Techniques: Where the Twain can meet*. Study prepared by the UNCTAD secretariat, 29 May 2006, pg. 6.

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[http://www.mondaq.com/turkey/x/445576/islamic+finance/Mostly+Used+Islamic+Finance+Instrument+Murabahah#\\_ftn2](http://www.mondaq.com/turkey/x/445576/islamic+finance/Mostly+Used+Islamic+Finance+Instrument+Murabahah#_ftn2). Accessed on 22 July 2017.

it is typically referred to as a “deferred sale” or “cost plus financing”.<sup>50</sup> In the price paid by the customer, the Islamic institution will add certain mark-ups. The mark-up is a function of the time between the moment that the goods are bought and the moment(s) the customer actually pays. Although according to Islamic scholars, this is not an interest rate, most banks will actually determine the mark-up on the basis of the interest rates prevailing in international markets – after all, Islamic banks do not operate in isolation but rather compete with interest-charging banks, both to attract depositors and to attract borrowers respectively.

### 3.2.1 REQUIREMENTS OF MURABAHAH

Based on the above, it appears that a murabahah at first instance is a sale transaction, where the bank buys an asset for a value on the demand of a third party and sells it for an increased price which is effectively calculated on the time value of money. However despite the apparent similarities to a conventional debt finance transaction, the following conditions of sale apply to murabahah to be deemed in compliance with Islamic law:<sup>51</sup>

- i. “The subject of sale must exist at the time of sale;
- ii. the seller must be the owner of the subject at the time of the second sale;
- iii. the subject of sale must be in physical or constructive possession of the seller;
- iv. the sale must have to be agreed and finalised on that place and time;
- v. the subject of sale must have a value;
- vi. the subject of sale must be used for a Halal<sup>52</sup> purpose;
- vii. the subject of sale must specifically be identified and known to the customer;
- viii. delivery of the sold subject to the customer must be certain and not depend on a probability or an unforeseen event;
- ix. the price must be definite for the validity of a sale; and
- x. the sale must be unconditional”.

It is noted that initially the murabahah was not considered as one of the modes of financing in that some scholars were of the opinion that it should not be utilised but rather used as an alternative where the mudarabah or musharakah were not practical. It follows therefore

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<sup>50</sup> *The World Islamic Banking Competitiveness Report, 2013-14, The Transition Begins*, Ernst and Young 2014.

<sup>51</sup> Usmani, M.T. 1998. *An introduction to Islamic finance*.

<http://islamicfinancenews.files.wordpress.com/2009/09/an20introduction20to20islamic20finance.pdf>, pg. 66.

<sup>52</sup> A permissible purpose according to the principles of Islamic Law.

that some scholars have allowed the use of a murabahah transaction provided certain conditions are met.<sup>53</sup> One of the conditions is that the word “interest” cannot be merely replaced with profit.<sup>54</sup>

Furthermore, the drafting of the contracts between the finance provider and the customer are critical in the permissibility of the agreement. Since the murabahah involves a sale, the principles of a permissible sale as mentioned above have to be adhered to. In addition, there has to be an underlying physical asset that is to be acquired. In this regard, the murabahah cannot be entered into to pay for an asset already acquired or for expenses which can be the subject of a loan in the conventional finance system.

In terms of Islamic law, one cannot sell an asset that is not owned as the finance provider is responsible for the risk. Further, it is permitted that the customer acts as an agent to buy the asset on behalf of the finance provider.<sup>55</sup> In this case the customer then acts as agent only without being responsible for the risk which resides with the finance provider. Ownership and risk is transferred on sale only. For the actual sale however, the asset has to be rightfully or legally owned by the seller (i.e. finance provider).<sup>56</sup>

Considering the above, it is important to note that the payment terms regarding the murabahah may be either at spot or on a subsequent date agreed upon by the parties.<sup>57</sup> In this regard, murabahah does not necessarily imply the concept of deferred payment, as generally understood in terms of its structure.<sup>58</sup> The murabahah, in its original Islamic form, is simply a sale where the main distinguishing element from other kinds of sales is the complete transparency in respect of the total cost and profit mark-up to be applied in relation to the transaction.<sup>59</sup> In practice, the murabahah is a buyer's credit that can be used for trade finance purposes such as consumer, intermediary and capital goods. However it is commonly used for long term structured project finance typically mortgages with deferred payment obligations (possibly in instalments due size of the purchase price

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<sup>53</sup> Supra N.51 pg. 72.

<sup>54</sup> Supra N.51 pg. 73.

<sup>55</sup> Id.

<sup>56</sup> Supra N.51 pg. 74.

<sup>57</sup> Supra N.51 pg. 65.

<sup>58</sup> Supra N.51 pg. 65.

<sup>59</sup> Supra N.51 pg. 66.

payable).<sup>60</sup> This perhaps may be the source of the perception regarding the murabahah deferred payment terms.

It is evident from the preceding section of the study, that collaboration between finance providers and Islamic scholars have enabled Islamic finance arrangements to be undertaken. They ostensibly aim to achieve a similar economic effect or outcome as conventional financial transactions without contravening Islamic principles. This chapter has up until now specifically considered the key issues surrounding Islamic finance as well as focussed on the murabahah instrument - widely used in Islamic finance from a domestic perspective. However, the focus now shifts to the concept of and issues surrounding a debt-claim which forms an integral part of the analysis.

### **3.3 A DEBT-CLAIM WITHIN CONVENTIONAL FINANCE**

In order to properly address the research question, the term “debt-claim” and its underlying precepts needs to be considered. It is important to note that South African law is a combination of two legal systems that have been effectively ‘merged’ – being initially Roman-Dutch law and subsequently English law. It is for this reason that South Africa is viewed as a mixed system.<sup>61</sup> Whilst English law tended to amend most of the Roman-Dutch legal principles, it has been generally accepted that Roman-Dutch law was maintained insofar as contract law was concerned.

In this regard, contract law forms part of the law of obligations. An obligation is a legal bond that requires one party to give, do or refrain from doing something to or for another party. This is in respect of a claim for money or something other than money too that may be required to be returned - it can be unconditional, conditional or perhaps at a later date.

It follows therefore that for the purposes of the dissertation and in the context of article 11, the focus will be on debt funding through the use of loans and the remuneration derived therefrom. South African law provides for two types of loans: a loan for use (*comadatum*) and a loan for consumption (*mutuum*). A loan for use arises when parties agree that one

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<sup>60</sup> Islamic Finance and Structured Community Finance Techniques: Where the Twain can meet. Study prepared by the UNCTAD secretariat, 29 May 2006, pg. 6.

<sup>61</sup> Van den Bergh “The Remarkable Survival of Roman Dutch Law in the Nineteenth Century South Africa” *Fundamina* (2012) pg.90 suggests that South African law is the merger of Roman-Dutch and English law which was forced to co-exist and eventually harmonised into a hybrid system.

party (the lender) gratuitously gives temporary use of a thing to the other party (the borrower) who subsequently returns exactly the same thing to the lender.<sup>62</sup> In contrast, a loan for consumption may be created when the lender gives ownership and possession of some tangible thing (a thing that is consumed by the use to which it is put) to the borrower who later delivers to the lender a thing of the same kind, quantity and quality.<sup>63</sup>

The two important features that depict a loan for use is that the contract is always gratuitous and that the thing itself must be returned after a certain period. In the absence of these requirements being met, the contract may fall within the ambit of a different category. As far as a loan for consumption is concerned, it typically involves the giving of a possession and the transfer of ownership of things that can be specifically measured, counted, or weighed (money as the most common example). As ownership of the thing lent is transferred to the borrower, they bear the risk of loss, damage or destruction of the thing. The loan need not be gratuitous, although this can typically be the case. It is important to note that the underlying basis of article 11 is that the action of lending money is remunerated in the form of interest.<sup>64</sup>

In this context, it therefore appears that a loan for consumption is more readily applicable to our discussion regarding a debt-claim particularly as the lender may charge for the use of the funds (debt capital) that has been made available. It follows that whilst a debt may be owing under both a loan for use and a loan for consumption, the distinction lies in whether it is gratuitous and the nature of the thing being borrowed and how used for the purposes of our discussion. It is evident that a debt-claim can be interpreted rather broadly but is derived from a formal legal contract between the parties. However, to complicate matters further, there does not appear to be a definition of this term for South African legal purposes. Nonetheless, this dissertation makes no assertions regarding the legal aspects surrounding a debt-claim, but only considers whether the subjectivity in its use and interpretation may possibly foster greater uncertainty regarding Islamic finance.

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<sup>62</sup> See F. du Bois (ed.) *Wille's Principles of South African Law* (Cape Town) (Juta 2007), pg. 948-956.

<sup>63</sup> *Id.* pg. 957-961.

<sup>64</sup> Preliminary remarks, para. 1 OECD Model: Commentary on Article 11 (2014).

### 3.4 MURABAHAH IN THE CONTEXT OF CONVENTIONAL DEBT FINANCE

As a general matter, the starting point in South Africa for determining the tax consequences of any transaction is its legal form. In this regard, South African taxation laws provide for both statutory and common law principles in certain instances to overcome this starting point, these substance-over-form rules are essentially designed as a deterrent against avoidance transactions. On the contrary there are not many provisions that typically exist to overcome form.

Therefore the concept of form with regards to Islamic finance works principally against Islamic investors. Largely due to the inability of structuring as a result of religious principles. In the absence of special legislation, these deviations in form may often preclude Islamic investors from certain tax treatment available to conventional finance. However, as previously discussed, these developments have led to various methods being adopted by countries to ‘modify’ their domestic tax laws in order to facilitate Islamic finance and thereby overcome these inherent disadvantages.

Whilst Islamic finance has been growing in importance, there remains a major distinction though, in that no interest can be charged — rather, the financial institution may charge a “mark-up” or share in the borrower’s profits. It appears to be nonetheless a contentious issue where the ‘debt-like’ arrangements like the murabahah have been deemed controversial.

Some consider them to be “against the spirit of Islamic finance and point to their financial and economic impact which does not seem to be quite different from the conventional debt. They argue that the Islamic financial instruments that are currently dominant in the industry (like murabahah) differ from their conventional counterparts only in terms of their legal lexicon but in essence have little financial or structural difference.”<sup>65</sup> Hence, it is posited that these instruments are not truly Islamic. Whilst others argue that the “dominant Islamic instruments such as murabahah undergo a rigorous process of Islamic law approval and are compliant with ‘juristically sound’ Islamic principles. Therefore these instruments are compliant, irrespective of their wider financial implications.”<sup>66</sup> The former blame the latter

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<sup>65</sup> Khan, F., 2010. *How ‘Islamic’ is Islamic Banking?* Journal of Economic Behaviour and Organization, Vol. 76, pg. 805-820.

<sup>66</sup> Ayub, M *Understanding Islamic Finance*. John Wiley & Sons (2009).

for relying too much on Islamic law and missing out on the spirit of the transactions while the latter blame the former on neglecting Islamic law and focusing too much on economic rationale. Therefore it can be seen that even within the Islamic finance industry itself, there appears to be conflicting views. This primarily concerns whether its underlying nature is akin to interest and debt funding.

This is in contrast to conventional debt finance (in essence a 'debt-claim') where the legal relationships underlying the payment of interest are exclusively those of debt-relationships. These are characterised by the fact that a person (the creditor) supplies finance to another person (the debtor) in such a manner that the debtor is obliged to repay this sum or a specific amount to the creditor, either by a specified time or on demand.<sup>67</sup>

An immediate difference in comparison to conventional finance is that the Islamic finance transaction requires that the financial institution participates in the risk of ownership of the asset. Furthermore, in the case of default of payment by the customer the price cannot be increased, however a penalty may be raised. The penalty though does not represent income to the financial institution and has to be distributed to a charitable cause.

From the above, it is clear that from an Islamic perspective, the murabahah arrangement is understood to not include or involve interest at all regardless of the presence of contrasting opinions on the compliance with Islamic law. These opposing views stem from the fact that the murabahah requires the finance provider to add an amount to the cost and this amount may be equivalent to interest rates relating to the date surrounding the arrangement. Despite this, the murabahah is still considered the Islamic financing technique most commonly adopted. Effectively, the murabahah is a simple and efficient financing tool for Islamic investors who do not wish to utilise conventional finance options.

However, it is interesting to note that in 2010, the Australian Board of Taxation conducted a review of Australia's tax laws to ensure that they do not impede the development of Islamic finance, banking and insurance products. In this regard, a Discussion Paper<sup>68</sup> on

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<sup>67</sup> See *Transfer prices and multinational corporations*, Report of the OECD Committee on Fiscal Affairs, 1979, pg.92.

<sup>68</sup> *Review of the taxation treatment of Islamic finance*, Discussion Paper, Australia Board of Taxation, October 2010.

the issues was released and the view taken was that the economic substance of the murabahah arrangement was in effect a conventional fixed interest loan backed by a mortgage, the interest element being seen as the 'profit'.<sup>69</sup>

It is evident that the purpose and structure of the murabahah arrangement is to enable a sale. However it is a transaction to be undertaken without resorting to an interest-bearing loan which would be prohibited under the rules governing Islamic finance. Nonetheless, the so-called 'mark-up' does appear to be a function of time. Whilst not seen as interest based on Islamic law, it is widely understood that the applicable 'mark-up' will be obtained externally in all likelihood at the prevailing market rates.

The principles of debt and interest are relatively clear with regards to conventional financing arrangements and the resultant withholding tax commonly applied. However they do not necessarily carry over easily to Islamic finance transactions. In the case of the murabahah transaction, when the customer pays the bank the required amount after twelve months, this is legally the delayed payment of the purchase price of the goods. To the extent this transaction is undertaken on a cross-border basis, it is not immediately obvious whether the country of source can require any withholding tax to be deducted from the payment. This issue will be considered further in the next chapter.

### **3.5 CONCLUSION**

From the preceding analysis various preliminary conclusions arise. The first is that Islamic finance is increasingly becoming a viable alternative to conventional finance. The inherent benefits are firmly based on the fact that the core principles that these financial arrangements are required to adhere to, are sustainable. It was contended that the murabahah instrument appears to be widely taken up by Islamic investors relative to other instruments.

The chapter notes that the nature of the murabahah instrument renders it similar to conventional loan finance in the context of a debt-claim because of the underlying economic substance and structure. It is important to note though that the deferred payment terms (similar to finance charges for a loan) under the murabahah, whilst common, is

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<sup>69</sup> Id. pg. 28.

merely optional and that the core requirement regarding the murabahah transaction is the complete transparency of the transaction. Interestingly, when determining their compliance with Islamic law, varying opinions have been put forward by respective scholars that either affirm or question its validity. This will add a further layer of complexity and confusion in the discussion.

Regardless, the awareness of cross-border Islamic finance transactions such as the murabahah in non-Muslim majority countries has increased. With Islamic investors looking to invest into new markets, it has been a natural progression due to cross-border trade that international tax principles be considered. Particularly as domestic tax adaptations have already occurred amongst countries looking to attract Islamic investors. Consequently, the comparison and contention between conventional finance is further highlighted.

A further observation that can be made is that the murabahah instrument, irrespective of its structure being compliant with Islamic law or whether involving interest or not, is still generally considered a debt arrangement from a contemporary finance perspective. The so called “mark-up” and deferred payment is deemed to take into consideration the time value of money, despite the Islamic principles, which is analogous to interest albeit in the absence of the legal framework. This rationale is supported by the domestic tax legislation adopted by South Africa, Malaysia, UK and Singapore that essentially qualify the murabahah instrument as a conventional loan and its related payment as interest (and so deductible for domestic income tax purposes). The chapter therefore examined common features of the murabahah to determine whether they could be considered as creating confusion and uncertainty with regards to a debt-claim.

Consideration was also had regarding the concept of a debt-claim and that from a South African contract law perspective, a debt-claim had certain conditions to be satisfied. In essence, for the purposes of the dissertation, a debt-claim is most likely to be seen in the context of a loan. In this regard, it appears that a loan for consumption as well as the loan for use are the most applicable for the purpose of our analysis. It is acknowledged that the legal analysis of a debt claim may be subjective as countries may differ in accordance with their legal framework.

It remains to be seen whether there is a consistent method or interpretation on the treatment of the murabahah transaction across different countries. As discussed, where the legal form of the transaction is more decisive for tax purposes (form over substance) special domestic tax legislation / guidance may be required. However there does not appear to be uniformity in the manner in which South Africa, Malaysia, UK, Singapore and Luxembourg have overcome this challenge. To the extent Islamic finance arrangements are not cross-border, the domestic amendments appear to have addressed the issues concerned.

Therefore, should there be cross-border Islamic finance arrangements such as the murabahah, it appears that legislation adaptations / amendments are critical in enabling tax neutral treatment under domestic law (i.e. South Africa adopting a deemed interest methodology to achieve this). This may present a challenge with no consensus or agreement on whether a substantial interpretation of the economic substance can impact the application of article 11 for international tax purposes. The use of the murabahah instrument in facilitating international transactions are set out next as part of discussing whether tax issues with regards to article 11 and a debt-claim arise.

## CHAPTER FOUR

### ARTICLE 11 OF THE OECD MODEL IN THE CONTEXT OF ISLAMIC FINANCE

#### 4.1 INTRODUCTION

Passive income refers to income from investments. This is in contrast to “active income”, which is derived from personal or business activities. Specifically, “passive income” is:<sup>70</sup>

*A term used generally to describe investment income. ... The term is also used specifically (US) to refer to income from a passive activity such as rental income or businesses in which the recipient does not materially participate.*

Therefore, in comparison to active income, passive income does not arise from any direct effort, such as the provision of services or from any active business undertaking for the resultant income to arise. Rather the only action performed in respect of the derivation of passive income is the making of the initial investment.<sup>71</sup> It follows that income that arises from debt instruments, i.e. (generally) interest qualifies as passive income in this regard.

Article 11 of the OECD Model (2017) determines the taxing rights on interest income. This chapter undertakes an examination of the elements of article 11, including the historical background under which it was initially developed and its subsequent evolution. It follows that this chapter will further consider whether Islamic finance, specifically a murabahah instrument, creates uncertainty with regards to a debt-claim.

In terms of article 11, the right to tax interest is allocated to the residence state. Whereas the source state’s ability to tax is limited to 10%. Similar to the other passive income articles, a permanent establishment (“PE”) proviso is also included in the interest article. In this regard, the taxing provisions above, may not be applicable to the extent the recipient of the interest carries on business through a PE in the other state. As such, the 10% source

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<sup>70</sup> Rogers-Glabush, J. (ed.), *International Tax Glossary*, Amsterdam: International Bureau of Fiscal Documentation, 2009, 6th ed. at <http://online.ibfd.org/kbase>.

<sup>71</sup> Kevin Holmes, *International Tax Policy and Double Tax Treaties – An Introduction to Principles and Application* (Second Revised Edition) - Online Books, Chapter 12.

state taxing limitation does not apply and the source state taxing right is unlimited.<sup>72</sup> Furthermore, article 11(6) provides for a limitation on the portion of interest, paid between associated parties that exceeds an arm's length amount. The interest article does not apply to the excess amount. Despite the above, deviation is common from the OECD Model (2017) in actual tax treaties as the items covered by the interest article vary in different tax treaties.

This chapter, will provide an overview of the international tax principles that govern cross-border investments in the form of debt as provided in article 11. It is evident that there is an established framework in respect of the interest article that provides guidance as to its practical application. In this regard it appears to provide for a clear balance and understanding of the tax implications for both the residence and source states that are party to cross-border investments using debt finance. What follows is an examination of whether non-traditional finance arrangements such as Islamic finance could disturb this balance and inadvertently create confusion and reduce legal certainty with respect to article 11 of the OECD Model (2017) and a debt-claim.

#### **4.2 TAXING RIGHTS UNDER ARTICLE 11 OF THE OECD MODEL**

In terms of article 11, the source state's right to tax is restricted to a subjective percentage only to the extent the recipient of the interest is the beneficial owner. The tax charged at source may constitute an advance on the tax. In cross-border situations, however, taxation in the source state leads to the risk of international double taxation. In addition, the source state tax is usually imposed on gross interest and generally does not take into account interest expenses and other costs incurred in deriving the income.<sup>73</sup> It follows that double taxation and gross-basis taxation of interest is harmful, as it can considerably reduce the net amount derived for money lent and, therefore, hamper the movement of capital and the development of international investment.<sup>74</sup>

The practical implication on domestic law is that essentially taxing rights will be allocated between the parties concerned based on the bilateral treaty text. Tax treaties therefore limit

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<sup>72</sup> The treatment should not, however, result in discrimination contrary to the non-discrimination article, article 24 of the OECD Model (2014).

<sup>73</sup> In order to address this issue, contracting states may wish to consider an exemption for, for example, banks. See para. 7.7 OECD Model Tax Convention on Income and on Capital: Commentary on Article 11 (2014).

<sup>74</sup> Paras. 2 and 7.1 OECD Model: Commentary on Article 11 (2014).

the taxing rights as oppose to extending the taxing rights however should the treaty text include references to domestic law, it may change the allocation. At present the OECD Model (2017) does not set any requirement on the contracting states to tax. There are many states though that do not tax interest income received by non-residents.<sup>75</sup>

A one-state-only approach may perhaps be a solution to eliminate the harmful effects of double taxation, however the OECD Model (2017) provides for a compromise. It was considered necessary, as it was unlikely that a one-state-only taxation approach would have received general approval.<sup>76</sup>

Therefore, to properly understand this compromise in the appropriate context, it is crucial to consider the history of article 11 of the OECD Model (2017). In doing so, an appreciation of the evolution of the interest article can be gained. Thereby allowing for a more informed discussion on whether Islamic finance is compatible with a debt-claim. The absence thereof, may foster an environment where uncertainty is enabled which may impede the facilitation of cross-border Islamic finance arrangements. This may inadvertently create opportunities for either double taxation or non-taxation which certainly represents obstacles to the development of economic relations between countries.<sup>77</sup>

#### **4.3 THE HISTORY OF ARTICLE 11 OF THE OECD MODEL**

An important observation that can be made is that article 11 of the OECD Model (2017) was not formulated in a vacuum. The interest article was developed over a period of time with input from a wide variety of stakeholders. It follows that the formulation of the interest article in tax treaties is derived from the age of the tax treaty concerned and as previously mentioned there is considerable deviation in treaty practice globally. This is illustrated by the following discussion on the development of the article prior to its current form in the OECD Model (2017). This provides the necessary context in which to understand and partly address our research problem.

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<sup>75</sup> Examples of such states include Estonia, Hong Kong, New Zealand and the Nordic Countries, i.e. Denmark, Finland, Norway and Sweden.

<sup>76</sup> Para. 3 OECD Model: Commentary on Article 11 (2014).

<sup>77</sup> See para. 1, Introduction to the OECD Model (2014).

### 4.3.1 THE EARLY MODELS PRIOR TO THE OECD

The OECD Model Tax Convention was largely “derived from the League of Nations Models which were in turn strongly influenced by the treaty practice of mainland European countries at that time.”<sup>78</sup> In this regard the OECD Model Tax Convention exists formally in only English and French; therefore terms that originate in other languages have been translated at best.<sup>79</sup>

The League of Nations began investigating the issues regarding juridical double taxation, as a result of a request coming from the 1920 Brussels International Financial Conference. In 1923 a *Report on Double Taxation*, prepared by four fiscal economists at the time<sup>80</sup>, was submitted to the League of Nations’s Economic and Financial Commission. That report formed the basis of the first draft model published in 1928. It was silent on the term “interest” but article 3 of the draft Model Convention 1A included in the report did in fact consider interest income.<sup>81</sup> Article 3 of the draft Model Convention 1A provided a list of income covered by the article, comprising “income from public funds, bonds, including mortgage bonds, loans and deposits or current accounts”. According to article 3 of the draft Model Convention 1A, income from these instruments would be “taxable in the State in which the debtors of such income are at the time resident”. Therefore, the taxing rights resided with the source state, however, no reference was made to the domestic law. Due to the first draft model being limited in issues dealt with, the League of Nations established its Fiscal Committee in 1929 to consider further developments.<sup>82</sup>

The Fiscal Committee continued its work over the following decade, culminating in regional conferences in 1940 and 1943 in Mexico City of representatives of countries in North and South America. The outcome of those conferences was a new draft.<sup>83</sup> In the

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<sup>78</sup> John Avery Jones et al., 2006. *The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States* – Bulletin Tax Treaty Monitor pg. 220.

<sup>79</sup> Id. Pg.221.

<sup>80</sup> Professors M. Bruins (Netherlands), M. Einaudi (Italy), E.R.A. Seligman (United States) and Sir Josiah Stamp (United Kingdom).

<sup>81</sup> For Draft 1a (1928), see *League of Nations, Double Taxation and Tax Evasion, Report* presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, Geneva, doc. C.562.M.178.1928.II pp. 7-15 (Feb. 1928), available at [http://ibfd.ent.sirsidynix.net.uk/client/external/search/detailnonmodal/ent:\\$002f\\$002fSD\\_ILS\\$002f53\\$002fSD\\_ILS:53879/IBFD-Tax-Research-Platform](http://ibfd.ent.sirsidynix.net.uk/client/external/search/detailnonmodal/ent:$002f$002fSD_ILS$002f53$002fSD_ILS:53879/IBFD-Tax-Research-Platform).

<sup>82</sup> Kevin Holmes, *International Tax Policy and Double Tax Treaties – An Introduction to Principles and Application* (Second Revised Edition) - Online Books, Chapter 3.

<sup>83</sup> For the Mexico Model (1943), see *League of Nations, London and Mexico Model Tax Conventions – Commentary and Text*, doc. C.88.M.88.1946.II.A., Geneva p. 58 (Nov. 1946), available at

Mexico Model (1943), interest and dividends were covered by the same article, concerning income from movable capital.<sup>84</sup> The term “interest” was still absent and no definition included. According to article IX of the Mexico Model (1943), income from movable capital would be “taxable only in the contracting State where such capital is invested”. The draft, therefore, allocated an exclusive taxing right to the source state.

The League of Nations again published the revised draft London Model (1946).<sup>85</sup> The London Model (1946) finally raised the issue of “interest” and included a separate article concerning interest income.

According to article IX:

*[i]nterest on bonds, securities, notes, debentures or on any other form of indebtedness shall be taxable only in the State where the creditor has his fiscal domicile. The state of the debtor, however, is entitled to tax such interest by means of deduction or withholding at source. The tax withheld at source is in no case to exceed \_\_\_% of the taxed interest.*

The London Model (1946) therefore appeared to make an allowance for dual or shared taxing rights on interest as well as introduced a list of the instruments considered to produce interest income.

The principles of the Mexico and London draft models were followed during the period 1946-1955, however, these models had several unresolved issues and consequently were not fully accepted or unanimously followed and therefore not reflective of actual treaty practice during that period.<sup>86</sup>

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[http://ibfd.ent.sirsidynix.net.uk/client/external/search/detailnonmodal/ent:\\$002f\\$002fSD\\_ILS\\$002f53\\$002fSD\\_ILS:53803/IBFD-Tax-Research-Platform](http://ibfd.ent.sirsidynix.net.uk/client/external/search/detailnonmodal/ent:$002f$002fSD_ILS$002f53$002fSD_ILS:53803/IBFD-Tax-Research-Platform).

<sup>84</sup> Art. IX Mexico Model (1943).

<sup>85</sup> For the London Model (1946), see *League of Nations, London and Mexico Model Tax Conventions – Commentary and Text*, doc. C.88.M.88.1946.II.A., Geneva p. 59 (Nov. 1946), available at [http://ibfd.ent.sirsidynix.net.uk/client/external/search/detailnonmodal/ent:\\$002f\\$002fSD\\_ILS\\$002f53\\$002fSD\\_ILS:53803/IBFD-Tax-Research-Platform](http://ibfd.ent.sirsidynix.net.uk/client/external/search/detailnonmodal/ent:$002f$002fSD_ILS$002f53$002fSD_ILS:53803/IBFD-Tax-Research-Platform).

<sup>86</sup> Kevin Holmes, *International Tax Policy and Double Tax Treaties – An Introduction to Principles and Application* (Second Revised Edition) - Online Books, Chapter 3.

It follows that several elements that form part of the current article 11 definition of interest originate from domestic regulations predominantly in Western Europe at that time:<sup>87</sup> mortgage interest was not seen as interest in Switzerland nor in the Netherlands (prior to 1990), but was treated as such in France and Germany.<sup>88</sup> Whereas penalties for late payment were deemed interest in Italy, but only sometimes in Switzerland, and never in France and Belgium. Furthermore, prizes attaching to securities were found in government securities in Sweden. It follows that a list of examples of the items to which article 11 applies can be found in some older Western European tax treaties.<sup>89</sup> This can be seen in old treaties where mortgage interest sometimes came within the immovable property article, and interest on mortgage bonds sometimes within the interest article.<sup>90</sup>

The above has illustrated that significant elements of the interest concept all have their origin in some shape or form in an earlier bilateral tax treaty. It follows that the history of the interest article, can be largely traced mostly to the domestic law and / or treaties of the Western European countries, which led the treaty practice after World War I.<sup>91</sup>

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<sup>87</sup> John Avery Jones et al., 2006. *The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States – Bulletin Tax Treaty Monitor* pg. 244-245.

<sup>88</sup> Carroll, Mitchell B., *Taxation of Foreign and National Enterprises* (Geneva: League of Nations, 1932 (Vol. 1) and 1933 (Vols. 2 and 3), Vol. 1 at 113. Some early treaties excluded mortgage interest from the immovable property article; e.g. Czechoslovakia–Germany (1921), Austria–Germany (1922) (although such interest was to be taxed exclusively by the state in which the mortgaged property was situated).

<sup>89</sup> Id. See Austria–Hungary (1922) (“interest on savings bank deposits or deposits on current accounts in banks and other credit institutions”); Austria–Poland (1932) (“... in particular interest and income from invested savings, uncharged claims, bonds and debentures, deposits on deposit or current account and securities of any kind”, referring to internal law); Czechoslovakia–Italy (1924) (“...interest on securities issued by shareholders’ companies, banks, or other credit institutions”); Germany–Italy (1925) (in which “interest on savings deposits and deposits on current account deposits in banks, institutions and other enterprises conducting credit operations” is defined to exclude interest on current commercial accounts); Hungary–Italy (1925) (containing the same definition and referring to “interest paid in respect of loans contracted by the State, Provinces, Communes or other public corporate bodies regularly constituted in conformity with the internal legislation of the contracting States, and on interest on bonds issued by companies or other legal entities”; also referring to the Hungarian legislation on “interest on bonds, and on interest on savings deposits or current account deposits”, which is also found in Hungary–Poland (1928)); Italy–Austria (1922), Hungary–Kingdom of the Serbs, Croats and Slovenes (1928) (“Interest on bonds issued by the State or by public autonomous corporations or by joint stock companies, banks or other financial institutions” and “interest on capital deposited in banks and other financial institutions in the form of savings deposits or on current account”); and Romania–Yugoslavia (1933) (making a distinction between state and private bonds). US–Canada (1942) contained a definition: “The term ‘interest,’ as used in this Convention, shall include income arising from interest-bearing securities, public obligations, mortgages, hypothecs, corporate bonds, loans, deposits and current accounts.”

<sup>90</sup> Income from mortgage bonds was treated as interest in the 1927 League of Nations Draft and 1928 Draft 1a. Mortgage interest was included as income from immovable property in the 1928 Drafts and also in the 1931 Draft and the Mexico and London Drafts. In the OEEC Second Report, the immovable property article did not deal with mortgage interest as the Commentary stated that this would be dealt with in the interest article; it was dealt with in OEEC Fourth Report.

<sup>91</sup> *Supra* N.89 pg. 244.

### 4.3.2 THE OEEC / OECD MODEL CONVENTIONS UNTIL 1977

The United Nations succeeded the League of Nations (in 1945), and the newly formed Economic and Social Council of the United Nations took over review and development of the League's London draft. Consequently, the council established a fiscal commission to do this; however, by 1954 the commission had made no significant progress in this regard. Therefore in 1955, delegates from the Netherlands, Switzerland and Germany proposed that a group of experts be established to examine special questions related to tax treaties between the Organisation for European Economic Co-operation ("OEEC") member countries.<sup>92</sup> Avoidance of double taxation on investment income, including dividends and interest income, was included in this regard.

The Fiscal Committee of the OEEC was formally established in 1956,<sup>93</sup> and the tax treatment of interest income was topical issue the committee agreed to review. In 1958, Working Party ("WP") 11 was established to study interest taxation and consisted of France and Belgium.<sup>94</sup> Concurrently, WP 12 was also established that was composed of Germany, Italy and Switzerland, to study the taxation of dividends. WP 11 issued four reports between 1959 and 1961.<sup>95</sup> The working method was understood to be undertaken by reviewing current treaty practice particular by its own members.

The first report of WP 11, released in 1959, developed a definition of interest income. Based on the report, interest income covers income from:

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<sup>92</sup> OEEC, Proposal by the Netherland, Swiss and German Delegations Concerning Double Taxation Questions to be Discussed by a Group of Taxation Experts which should be set up within the O.E.E.C, Paris, doc. C(55)307 (9 Dec. 1955), available at [http://taxtreatieshistory.org/data/html/C\(55\)307E.html](http://taxtreatieshistory.org/data/html/C(55)307E.html).

<sup>93</sup> OEEC, Council Report of the Ad Hoc Group of Experts on Fiscal Questions, Paris, doc. C(5)49 (24 Feb. 1956), available at [http://taxtreatieshistory.org/data/html/C\(5\)49E.html](http://taxtreatieshistory.org/data/html/C(5)49E.html).

<sup>94</sup> OEEC, Minutes of the 7th Session held on Tuesday 25th, Wednesday 26th and Thursday 27th March 1958, Paris, doc. FC/M(58)2 (29 Mar. 1958), available at [http://taxtreatieshistory.org/data/html/FC-M\(58\)2E.html](http://taxtreatieshistory.org/data/html/FC-M(58)2E.html).

<sup>95</sup> OEEC, Working Party No. 11 of the Fiscal Committee (France and Belgium) – Report on the Taxation of Interest, Paris, doc. FC/WP11(59)1 (15 Jan. 1959), available at [http://taxtreatieshistory.org/data/html/FC-WP11\(59\)1E.html](http://taxtreatieshistory.org/data/html/FC-WP11(59)1E.html); Working Party No. 11 of the Fiscal Committee (France and Belgium) – Second Report on the Taxation of Interest, Paris, doc. FC/WP11(60)1 (3 May 1960), available at [http://taxtreatieshistory.org/data/html/FC-WP11\(60\)1E.html](http://taxtreatieshistory.org/data/html/FC-WP11(60)1E.html); Working Party No. 11 of the Fiscal Committee (France and Belgium) – Third Report on the Taxation of Interest, Paris, doc. FC/WP11(60)2 (20 Oct. 1960), available at [http://taxtreatieshistory.org/data/html/FC-WP11\(60\)2E.html](http://taxtreatieshistory.org/data/html/FC-WP11(60)2E.html); Working Party No. 11 of the Fiscal Committee (France and Belgium) – Fourth Report on the Taxation of Interest, Paris, doc. FC/WP11(61)1 (1 Mar. 1961), available at [http://taxtreatieshistory.org/data/html/FC-WP11\(61\)1E.html](http://taxtreatieshistory.org/data/html/FC-WP11(61)1E.html); and Working Party No. 11 of the Fiscal Committee (France and Belgium) – Revised Fourth Report on the Taxation of Interest, Paris, doc. FC/WP11(61)2 (10 Apr. 1961), available at [http://taxtreatieshistory.org/data/html/FC-WP11\(61\)2E.html](http://taxtreatieshistory.org/data/html/FC-WP11(61)2E.html).

- i. bonds or debentures, whether or not secured on immovable property and whether or not carrying a right to participate in profits ...;
- ii. government securities;
- iii. indebtedness or debt-claims of every kind ...; and
- iv. notes of indebtedness, deposits, cash guarantees and other capital assets which can be assimilated to debt-claims or loans.<sup>96</sup>

This illustrates the practical formulation process, as both WP11 members excluded penalties for late payments from the definition of interest which was consistent with their respective domestic tax law. This may have arguably influenced the negotiations as it appears that penalties were not subsequently included in the definition (and remains so).

The provisions of the interest article would not apply to any interest exceeding “a just and reasonable rate”.<sup>97</sup> A compromise was suggested for the division of taxing rights on interest income, as it was clear that some states favoured exclusive residence state taxing rights and some states exclusive source state taxing rights.<sup>98</sup> The taxing rights on interest income would be divided or shared between the source state and the residence state of the recipient of interest income; a reduced rate would be applied in the source state and a foreign tax credit would be provided in the residence state. The reduced source state tax rate was later agreed to be 10%.<sup>99</sup> A specific provision concerning situations in which the interest recipient has a PE in the source state was proposed in the first report of WP 11. The PE state was proposed to have unlimited taxing rights on interest income in that regard.<sup>100</sup>

The compromise solution of divided or shared taxing rights was confirmed in the second report of WP 11. In contrast to the original proposal, however, the elimination of double taxation would be dealt with in a separate article.<sup>101</sup> The PE state provision was clarified by specifications that the force of attraction principle would not apply and that the PE

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<sup>96</sup> OEEC, Working Party No. 11 of the Fiscal Committee (France and Belgium) – Report on the Taxation of Interest, Paris, doc. FC/WP11(59)1 (15 Jan. 1959), available at [http://taxtreatieshistory.org/data/html/FC-WP11\(59\)1E.html](http://taxtreatieshistory.org/data/html/FC-WP11(59)1E.html), at pp. 1-2.

<sup>97</sup> *Id.*, at pg. 13.

<sup>98</sup> *Id.*, at pg. 5.

<sup>99</sup> OEEC, Minutes of the 17th Session held on Tuesday 29th, Wednesday 30th, Thursday 31st and Friday 1st April 1960, Paris, doc. FC/M(60) 2 (28 Apr. 1960), available at [http://taxtreatieshistory.org/data/html/FC-M\(60\)2E.html](http://taxtreatieshistory.org/data/html/FC-M(60)2E.html).

<sup>100</sup> OEEC, Working Party No. 11 of the Fiscal Committee (France and Belgium) – Report on the Taxation of Interest, Paris, doc. FC/WP11(59)1 (15 Jan. 1959), available at [http://taxtreatieshistory.org/data/html/FC-WP11\(59\)1E.html](http://taxtreatieshistory.org/data/html/FC-WP11(59)1E.html), at pg. 9.

<sup>101</sup> *Id.*, at pg. 2.

provision would apply only to interest that is effectively connected to a PE. The definition of interest was not changed, but it was proposed that the provision concerning excessive interest should cover only situations in which the debtor and creditor have a special relationship.<sup>102</sup>

WP 11 could not reach a consensus on the source state taxing rights on interest. This meant that the third report<sup>103</sup> WP 11 submitted to the OEEC Fiscal Committee proposed a compromise, which included a maximum source state taxing right of 10%, together with possible reservations.<sup>104</sup> A concession was also reached concerning the definition of interest. The definition would be drafted to cover, in addition to the specifically mentioned income, income from “debt-claims of every kind, as well as all other income assimilated by the taxation law to income from money lent”.<sup>105</sup> In this regard, it was noted in the discussion that the text was modelled on provisions that were to be found in the taxation laws of many countries and specifically on stipulations already contained in international double taxation Conventions. (cf. France-Swiss Convention of 31st December, 1953, Final Protocol ad. Art. 10).<sup>106</sup> The provision concerning excessive interest was proposed to cover situations in which there is a special relationship between the debtor and the creditor or between both of them and a third person. That part of a payment exceeding an arm’s length amount would be considered a distribution of profits and taxed accordingly.<sup>107</sup>

The fourth report of WP 11<sup>108</sup> included a draft article on the taxation of interest. It was again based on divided or shared taxing rights between the residence state and the source state, with a maximum taxing right of 10% “on the amount of interest”.<sup>109</sup> As the source state taxing right was clearly a compromise, the proposed draft article stated that the competent authorities of the contracting states “shall by mutual agreement settle the mode

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<sup>102</sup> Id., at pg. 2.

<sup>103</sup> Working Party No. 11 of the Fiscal Committee (France and Belgium) – Third Report on the Taxation of Interest, Paris, doc. FC/WP11(60)2 (20 Oct. 1960), available at [http://taxtreatieshistory.org/data/html/FC-WP11\(60\)2E.html](http://taxtreatieshistory.org/data/html/FC-WP11(60)2E.html).

<sup>104</sup> Id., at pg. 2.

<sup>105</sup> Id., at pg. 3.

<sup>106</sup> Id., at pg 3.

<sup>107</sup> Id., at pg. 4-6.

<sup>108</sup> Working Party No. 11 of the Fiscal Committee (France and Belgium) – Fourth Report on the Taxation of Interest, Paris, doc. FC/WP11(61)1 (1 Mar. 1961), available at [http://taxtreatieshistory.org/data/html/FC-WP11\(61\)1E.html](http://taxtreatieshistory.org/data/html/FC-WP11(61)1E.html); Economic double taxation may be the consequence in these situations. See K. Vogel, *Klaus Vogel on Double Taxation Conventions* 3rd ed., pg. 715 (Kluwer 1997).

<sup>109</sup> Id., at para. 1 and 2.

of application of the limitation”.<sup>110</sup> This updated version again included a reference to domestic law in the definition of interest. The definition covered, in addition to the specifically mentioned income, income from “debt-claims of every kind, as well as all other income assimilated by the taxation law to income from money lent”.<sup>111</sup> The paragraph concerning PEs would apply when the debt-claim from which interest arises “is effectively connected” with the PE.<sup>112</sup> It, therefore, did not include the force of attraction principle regarding PEs. The provision defining the state in which interest arises was clarified in respect of the situations in which interest arises in a PE state. A new subparagraph provided that the payer of the interest need not be resident in one of the contracting states.<sup>113</sup> The provision on excessive interest was drafted to cover situations in which a special relationship existed for which the amount of interest exceeded an arm’s length amount. The excess amount would be “taxable in accordance with the laws of the Contracting States, due regard being had to the other provisions” of a tax treaty.<sup>114</sup>

In 1960, the OEEC transformed into the OECD which consisted largely of Western European countries and many of which were developed countries and capital exporters. It follows that based on the efforts of WP 11, the OECD Fiscal Committee agreed on the articles for the OECD Draft (1963)<sup>115</sup> which reflected the interests of the OECD membership primarily.

The interest article of the OECD Draft (1963) consisted of six paragraphs as proposed by WP 11. Those six paragraphs were largely derived from the paragraphs as set out by WP 11. According to article 11(1) of the OECD Draft (1963) provided that “[i]nterest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other state”.

Whereas article 11(2) of the OECD Draft (1963), stated:

*such interest may then be taxed in the Contracting State in which it arises, according to the law of that state, but the tax so charged shall not exceed 10 per*

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<sup>110</sup> Id., at para. 2.

<sup>111</sup> Id., at para. 3.

<sup>112</sup> Id., at para. 4.

<sup>113</sup> Id., at para. 5.

<sup>114</sup> Id., at para. 6.

<sup>115</sup> OECD Draft Tax Convention on Income and on Capital (30 July 1963).

*cent of the amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.*

The term “interest” was defined in article 11(3) of the OECD Draft (1963) for the purposes of that article but also included the reference to domestic law. It was specified that the relevant law is that of the state in which the interest arises. According to article 11(3) of the OECD Draft (1963), interest means:

*income from government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt-claims of every kind as well as all other income assimilated to income from money lent by the taxation law of the state in which the income arises.*

Article 11(4) of the OECD Draft (1963) included the PE provision. According to that provision, article 11(1) and (2) of the OECD Draft (1963) does not apply:

*if the recipient of the interest, being a resident of a Contracting State, has in the other Contracting State in which the interest arises a permanent establishment with which the debt-claim from which the interest arises is effectively connected.*

Article 11(5) of the OECD Draft (1963) defined the state in which interest was considered to arise. The provision adopted the ideas of the draft article included in the fourth report of WP 11,<sup>116</sup> but it was structured differently and included in one paragraph:

*Interest shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority or a resident of that state. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment*

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<sup>116</sup> Working Party No. 11 of the Fiscal Committee (France and Belgium) – Fourth Report on the Taxation of Interest, Paris, doc. FC/WP11(61)1 (1 Mar. 1961), available at [http://taxtreatieshistory.org/data/html/FC-WP11\(61\)1E.html](http://taxtreatieshistory.org/data/html/FC-WP11(61)1E.html); Economic double taxation may be the consequence in these situations. See K. Vogel, *Klaus Vogel on Double Taxation Conventions* 3rd ed., pg. 715 (Kluwer 1997).

*in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the Contracting State in which the permanent establishment is situated.*

Article 11(6) of the OECD Draft (1963) included the provision concerning excessive interest. As proposed by WP 11 in its fourth report,<sup>117</sup> the provision applies only in the context of “a special relationship”. The phrase “at arm’s length” was no longer included in the provision; but, rather, the amount of the excess was to be determined by comparing the interest paid to the interest that would have been agreed upon in the absence of the special relationship. Article 11(6) of the OECD Draft (1963) reads in full:

*Where, owing to a special relationship between the payer and the recipient or between both of them and some other person, the amount of the interest paid, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.*

However, the Fiscal Committee of the OECD reworked the OECD Draft (1963) and subsequently published the revised OECD Model (1977).<sup>118</sup> The major development was that the reference to domestic law was removed from the definition of interest income. This change was understood to be in line with a general approach of avoiding references to domestic law as far as possible, a procedure considered to be better from the perspective of legal certainty.<sup>119</sup> Penalty charges for late payment were also specifically excluded from the definition of interest.

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<sup>117</sup> Id.

<sup>118</sup> OECD Model Tax Convention on Income and on Capital (11 April 1977).

<sup>119</sup> OECD Model Tax Convention on Income and on Capital: Commentary on Article 11 para. 19 (11 April 1977).

A further amendment was the inclusion of a beneficial ownership requirement in the interest article. In this regard, the beneficial ownership concept was added to article 11(2), 11(4) and 11(6) of the OECD Model (1977).

#### 4.3.3 THE OECD MODEL CONVENTION POST 1977

With a change in approach though, the OECD Model Tax Convention was published in loose-leaf format as an ambulatory model in 1992. Article 11 of the OECD Model (1977) remained unchanged in the OECD Model (1992).<sup>120</sup> However subsequent updates to the OECD Model (1992) were made in March 1994, September 1995 and November 1997. There were, however, only limited amendments made to article 11.

The OECD Model (1995)<sup>121</sup> added a clarifying amendment to the beneficial ownership requirement included in article 11(2). The amendment provided that the beneficial owner of the interest must be a resident of the other contracting state. This was not sufficient however, as, until this amendment, the recipient is the beneficial owner for the source state limitation on taxing rights to apply.<sup>122</sup> The OECD Model (1995) also deleted the words “that State itself, a political subdivision, a local authority or” from the first sentence of article 11(5), which determines the state in which interest is deemed to arise. The deleted phrase became unnecessary after the definition of the term “resident of a contracting state” in article 4 was amended to cover a state “or any political subdivision or local authority thereof”.<sup>123</sup> A new paragraph regarding non-traditional financial instruments was added to the Commentary on Article 11 of the OECD Model (1995).<sup>124</sup>

In April 2000, a revised version of the ambulatory OECD Model (2000)<sup>125</sup> was published. The OECD Model (2000)<sup>126</sup> included amendments to article 11(4) and (5).

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<sup>120</sup> OECD Model Tax Convention on Income and on Capital (1 September 1992). Some amendments were made in the OECD Model: Commentary on Article 11 (1977), including a new paragraph on participating bonds, i.e. para.19, and amendments to the commentary concerning excessive interest, i.e. paras. 32 to 36.

<sup>121</sup> OECD Comm. on Fiscal Affairs, the 1995 Update to the Model Tax Convention (OECD 1995).

<sup>122</sup> A more detailed explanation of the term “beneficial owner” was later, in 2003, included in paragraph 9 of OECD Model: Commentary on Article 11 (1977). See OECD Model Tax Convention on Income and on Capital: Commentary on Article 11 para. 8.2. (1 January 2003).

<sup>123</sup> For the history of article 4, see Global Tax Treaty Commentaries (GTTC) Chapter on Article 4.

<sup>124</sup> OECD Model Tax Convention on Income and on Capital: Commentary on Article 11 para. 21.1 (1995). Added by OECD Council Recommendation C(95)132/FINAL (21 September 1995).

<sup>125</sup> OECD Model Tax Convention on Income and on Capital (29 April 2000).

<sup>126</sup> OECD Comm. on Fiscal Affairs, the 2000 Update to the OECD Model Tax Convention (OECD 2000).

The references to independent personal services and to a fixed base that were included in the OECD Model (1977) were removed to reflect the removal of article 14 on independent personal services.<sup>127</sup> Since the OECD Model (2000), the OECD Model Tax Convention has not included the concept of a fixed base.

The next revision was in the OECD Model (2003),<sup>128</sup> but article 11 was not amended. New, more detailed paragraphs concerning the concept of a beneficial owner were, however, added in the Commentary on Article 11 of the OECD Model (2003)<sup>129</sup> and a new paragraph, concerning the abusive transfers of loans to PEs, was introduced.<sup>130</sup> The OECD Model (2005),<sup>131</sup> The OECD Model (2008),<sup>132</sup> the OECD Model (2010)<sup>133</sup> and subsequent changes preceding the OECD Model (2014) did not include any amendments to article 11, but some clarifications were added to the Commentary on Article 11 of the relevant models. The OECD Model (2014) also revised the discussion in the OECD Commentary on Article 11 regarding the concept of beneficial owner.<sup>134</sup>

#### **4.4 INTEREST IN ARTICLE 11 IN THE CONTEXT OF CROSS-BORDER ISLAMIC FINANCE**

The term “interest” takes on different meanings in different jurisdictions. In South African income tax legislation, the term has not been defined. However, the *Shorter Oxford Dictionary* defines the word “interest” as “money paid for the use of money lent or for the forbearance of a debt”. South African case law appears to be consistent with the common law meaning regarding the concept of interest.<sup>135</sup>

The International Bureau of Fiscal Documentation (“IBFD”), through their online glossary refers to ‘interest’ as follows:

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<sup>127</sup> The removal was based on OECD Comm. on Fiscal Affairs, Issues related to Article 14 of the OECD Model Tax Convention (OECD 2000), International Organisations’ Documentation IBFD. For the history of article 14, see section 1.2. of the Global Tax Treaty Commentaries (GTTC) Chapter on Article 14.

<sup>128</sup> OECD Model Tax Convention on Income and on Capital (1 January 2003).

<sup>129</sup> Paras. 8-8.2 OECD Model: Commentary on Article 11 (2003).

<sup>130</sup> *Id.*, at para. 25.

<sup>131</sup> OECD Model Tax Convention on Income and on Capital (15 July 2005).

<sup>132</sup> OECD Model Tax Convention on Income and on Capital (17 July 2008).

<sup>133</sup> OECD Model Tax Convention on Income and on Capital (22 July 2010).

<sup>134</sup> See para. 9-11 OECD Model: Commentary on Article 11 (2014).

<sup>135</sup> Commissioner for Inland Revenue v Cactus Investments (Pty) Ltd 59 SATC 1.

*“In general, the amount charged by a lender for the use or detention of money, expressed as a percentage per annum of the principal amount of the loan over a certain period of time. However, whether a particular payment constitutes interest will depend on the country whose tax rules are being applied. Most tax treaties contain their own definition of interest that is independent of the definitions under domestic laws”.*

In treaty law, the meaning is in essence compensation for money advanced and put simply is “any income from a debt-claim”. “Income”, “from” and “debt-claim” are the three constituent elements of the definition. Article 11(3) of the OECD Model (1977-2017)<sup>136</sup> reads, rather lengthy:

*The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.*

In light of the above, the term “interest” is explicitly defined in article 11(3) for the purposes of the application of article 11. It is possible, therefore, that, for the purposes of the other articles of the OECD Model, the term “interest” has a different meaning. For the purposes of the whole of article 11, however, the definition of article 11(3) is decisive.

The definition of interest is broad, and it does not contain any reference to the classification of items of income in domestic law. The Commentary on Article 11 explains that the definition is exhaustive.<sup>137</sup>

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<sup>136</sup> The only change in the OECD interest definition occurred in the 1977 Model. Since then, the definition has remained the same.

<sup>137</sup> Para. 21 OECD Model: Commentary on Article 11 (2014).

The classification of an item of income for the purposes of the domestic tax laws of the contracting states is, therefore inconsequential.<sup>138</sup>

The classification under domestic law may, however, have relevance indirectly, as the dividend article refers to that classification<sup>139</sup> and/or because of the interpretative rule in article 3(2), which refers to domestic law in the case of undefined treaty terms.<sup>140</sup>

The undefined terms used in the exhaustive treaty definition may have to be given a meaning that accords with the domestic law of the state applying the tax treaty, unless the context requires an autonomous meaning.<sup>141</sup> Canada and the UK have made a specific observation to the Commentary on Article 11 of the OECD Model (2014).<sup>142</sup>

Given the above, “interest” is nothing more than a shorthand term that consists of its constituent elements: income / from / debt-claims. Furthermore, as previously mentioned, income appears not to be automatically connected with a percentage approach on a principal. At first instance this article would therefore theoretically properly suit the context of Islamic finance arrangements.

Nonetheless, the definition could have ceased at the first comma (“the term ‘interest’ as used in this Article means income from debt-claims of every kind”).<sup>143</sup> However, the extensive OECD definition can be explained by the history of the drafting process, as section 4.3 reveals. The definition, as it now is, was inspired by WP 11 and the tax treaty practice at the time when the OEEC drafted the interest article, i.e. tax treaties that were rather verbose. The OECD definition is more or less a common denominator

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<sup>138</sup> See para. 21 OECD Model: Commentary on Article 11 (2014) for how the interest definition of the OECD Model (2014) does not refer to domestic laws. However, para. 44 OECD Model: Commentary on Article 11 (2014) lists the reservations of Greece, Portugal and Spain to widening the definition of interest by including a reference to domestic laws. Australia, Italy and the United States have also, in practice, reserved the right, although they have not made specific reservations in this regard to the OECD Model: Commentary on Article 11 (2014). It is, however, considered that no reservation is required, because the OECD Model: Commentary on Article 11 (2014) permits variation in this respect. See J.F. Avery Jones et al., *The Definition of Dividends and Interest in the OECD Model: Something Lost in Translation?* British Tax Review 4, pg. 441 (2009), for this position.

<sup>139</sup> For a comprehensive discussion, see J. F. Avery Jones et al., *The Definition of Dividends and Interest in the OECD Model: Something Lost in Translation?* British Tax Review 4, at pg. 406-452 (2009).

<sup>140</sup> See section 7. of the GTTC Chapter on Treaty Interpretation, IBFD.

<sup>141</sup> There are examples of national court cases in which the domestic law definition has been granted relevance. See, for example, the decision of *The Queen v. Melford Developments Inc.* [1982] 2 SCR 504 (Supreme Court of Canada).

<sup>142</sup> Which state that certain interest payments are treated as distributions under their domestic legislation and are, therefore, dealt with under article 10 of the OECD Model (2014) instead of article 11.

<sup>143</sup> See H. Pijl, *Chapter 6: The Concept of Interest in Tax Treaties in Tax Treatment for Corporations*, Section 6.1, (O.C.R. Marres & D. (Dennis) Weber eds., IBFD 2013).

of the existing interest definitions in tax treaties of the first half of the 20<sup>th</sup> century. These definitions contained even more examples than the eventual OECD interest definition, which was already found to be too lengthy and was considerably abridged in the course of the drafting process. It follows therefore that the OECD interest definition was not a creation out of nothing where, under a pure, minimalistic, efficient, ideal use of language, only the necessary is said. This, again, reveals that, whilst treaty law is not poetry, it is also not a science but rather adapts and responds to contemporary international economic and business trade trends that may evolve over the course of time between countries.

#### **4.4.1 OPEN DEFINITION OF INTEREST IN OECD MODEL (1963)**

In 1963, it was thought that an exhaustive, closed definition of interest might not deal with the variations in what was considered to be interest at that time under domestic law. The interest definition in article 11(3) of the OECD Draft (1963) thus contained the open-ended formula “as well as all other income assimilated to income from money lent by the taxation law of the State in which the income arises”. Paragraph 25 of the Commentary on Article 11 of the OECD Draft (1963) explained that this formula could not be omitted:

*“... the Article does not give a complete and exhaustive list of the various kinds of interest. Such a list might not be fully in harmony with the various States’ laws, which may differ among themselves in their interpretation of the concept of interest. It therefore seems preferable to include in a general formula all income which is assimilated by those laws to remuneration on money lent. This applies in particular to interest derived from cash deposits and security lodged in money.”*

Given the above, the interest definition had next to the autonomous part a general non-autonomous clause that extended the definitions where the domestic law of the state of origin assimilated the income to interest. In effect, the state of origin determined the meaning of the terms. Importantly, it could be posited that issues of qualification were unlikely to arise, as the source state’s definition was also binding for the recipient state. Furthermore, the Commentary on article 11 of the OECD Draft (1963) thought it preferable not to give a complete and exhaustive list of the various kinds of interest due

to potential inconsistencies amongst the various states' laws. It follows that tax treaties concluded around this period of time included the above-mentioned definition.

#### **4.4.2 CLOSED DEFINITION OF INTEREST IN OECD MODEL (1977)**

In 1977, the open-ended definition of interest became closed, although this change was not generally accepted (which perhaps illustrates a practical example of the uncertainty immediately created). The point is that the process followed to amend article 11 perhaps suggests a degree of false consensus concerning the new closed definition. Evidence of such dissonance can be seen in the extent to which later reservations were made by several countries as well as individual states adopting their own variation of article 11. The interest definition was thus made exhaustive and the reference to domestic law was deleted. The reason advanced by the OECD Model Commentary (1977) was that the treaty definition contained everything that domestic laws normally regard as interest (presumably at that time) and that the reference to the source state's law was unnecessary. Paragraph 19 of the Commentary on Article 11 of the OECD Model (1977), which has been maintained unchanged as paragraph 21, stated:

*“... the definition of interest ... is, in principle, exhaustive. It has seemed preferable not to include a subsidiary reference to domestic laws in the text; this is justified by the following considerations:*

- a) the definition covers practically all the kinds of income which are regarded as interest in the various domestic laws;*
- b) the formula employed offers greater security from the legal point of view and ensures that conventions would be unaffected by future changes in any country's domestic laws;*
- c) in the Model Convention references to domestic laws should as far as possible be avoided.”*

With the above in mind, the explanations provided for the change cannot be posited as robust.<sup>144</sup> Reason a's weakness is in the use of the word “practically”, which already suggests that there are cases, where the domestic law is indeed wider than the tax treaty's interest definition. Reason c is contrary to the basic rule of interpretation (article

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<sup>144</sup> See Pijl. Interest from Hybrid Debts in Tax Treaties, 65 Bull Int. Taxn. 9, sec. 2.2. (2011), Journals IBFD.

3(2)) and does not discuss why the interest definition became closed, whereas the dividend definition remained open. As far as reason b is concerned, that could also be said about the definition of dividends, but that continued to be open.<sup>145</sup> Nonetheless, these arguments consistently appeared in the drafting documents that resulted in the OECD Model (1977) and it should be recognised that the Fiscal Committee also considered to close the definition and to remove its reference to domestic law.

It follows that the definition was deemed to be all encompassing and no further reference to domestic law was required. As can be seen from the above, the greater apparent legal certainty and the inability for states to change their domestic laws afterwards and thus disturb the historically agreed balance in the attribution of taxing rights, is therefore emphasized as the main leitmotif for the radical changes. The other argument was the perception that the treaty definition already contained everything domestic laws normally regard as interest. In addition, to the extent potential qualification issues arose, they were addressed in the Commentary.<sup>146</sup>

Although the changes compared to the OECD Draft 1963 do not seem overwhelming, they do deserve attention, as they could make a difference in the interpretation of treaties with the 1963 definition. Indeed, the 1963 and 1977 differences are not mere changes to the Commentary, they are embedded in the treaty text itself.

#### **4.4.3 TREATY PRACTICE IN ARTICLE 11 OF SELECTED COUNTRIES WITH AN ISLAMIC FINANCE TAX REGIME**

Following on from section 2.3.1 of the dissertation concerning domestic Islamic finance tax regimes, it is important to now consider what the individual countries tax treaty practice has been in light of their respective domestic adaptations. In essence understanding whether the article 11 OECD Model (2017) treaty text has been adopted and thereby indirectly whether Islamic finance has been taken into account.

In terms of the applicability of tax treaties with respect to Islamic financing, generally the tax treaties concluded by South Africa do not include any specific references accommodating Islamic finance. In this regard, as South African income tax legislation essentially adopts the deemed interest approach, there may be appear to be uncertainty

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<sup>145</sup> Id. At sec. 2.2.1.

<sup>146</sup> Where securities and bonds were sold, for example, the 1977 Commentary dictated that the sales proceeds were not interest, but were to be treated under article 7, 13 or 21 as the case might be.

created with respect to the interpretation of 'interest'. Furthermore, of the tax treaties entered into by South Africa, there is only limited inclusion of the open-ended interest definition. Whilst it is also interesting to note that none of the said tax treaties were concluded with any of the selected countries either.

From a Malaysian perspective, cross-border transactions involving non-resident borrowers would be afforded the same treatment as conventional borrowings from non-resident borrowers. Islamic 'profits' would be seen as interest for Malaysian income tax purposes. However, as a result of tax incentives provided to financial services, there is generally no withholding tax when profits or 'interest' is paid to a non-resident on Malaysian issued Islamic finance instruments. Regarding the use of the open-ended definition of interest, it appears that Malaysia has similarly not adopted this expanded version very widely across their tax treaties.

In the UK, the double tax treaties do not typically provide for Islamic finance arrangements or alternative finance type arrangements. For the purpose of applying the tax treaties concluded by the UK with other countries, the OECD guidelines and UK domestic law will need to be considered in determining the nature of returns / payments falling within the ambit of Islamic finance. In addition the instances where the UK tax treaties have made the inclusion of the open-ended definition seem to be more frequent in comparison to both South Africa and Malaysia. This may not arguably be in response to the establishment of an Islamic finance regime but perhaps merely in proportion to the greater number of tax treaties concluded by the UK.

Similarly, there is no specific provisions included in Singapore's tax treaties that take into account Islamic finance products. However, as the effective returns from these prescribed arrangements are treated as interest for tax purposes, there is no certainty that the tax authorities will view them as falling within the interest article of tax treaties which Singapore has concluded with respective treaty partners. This is particularly so to the extent the treaty definition of interest does not include payments that are assimilated to income from money lent under Singapore law. In light of this, Singapore in comparison to the other selected countries, has formally included the opened-ended interest definition within its tax treaties the least.

Based on the above, it can be seen that even though the respective countries have adopted Islamic finance tax regimes on a domestic level there has been no consistent integration in their respective tax treaties (as yet). Similarly there has not been an identifiable trend amongst the selected countries regarding the adoption of an open-ended definition of interest for the purposes of article 11. Where a reference to domestic law has been made, it is arguable (or rather unlikely mainly due to the timing) that the underlying reason for the adoption has been principally for the purpose of incorporating Islamic finance.

Given the above, it may at first instance seem as though no relationship exists between domestic and tax treaty practices across the selected countries in the context of Islamic finance. The objective of the OECD models (and the UN models) has been to provide some direction to countries planning to enter into a bilateral or multilateral tax treaty, and ostensibly to the extent possible, follow these models. However in the absence of a binding requirement, they are not enforceable and in essence just a model. In this regard, the models have merely acted as a starting point for the formulation of article 11 whereby the selected countries have thereafter tailored accordingly. It is evident that the selected countries have applied their own domestic legislation and techniques in practice and have only diverted from the OECD Model Tax Convention on a limited basis in light of their particular circumstances.

#### **4.5 ISLAMIC FINANCE AND DEBT-CLAIM UNDER ARTICLE 11**

Article 11's term "debt-claim"<sup>147</sup> should be taken in its legal meaning, i.e. as a loan instrument under contract law. In South African law the most relevant contract may be a loan for consumption (*mutuum*) which is subject to certain the specific requirements being met as previously discussed. This could be further supported by South African case law's interpretation regarding "interest" and whether received as a result of the loan for consumption contract. Nonetheless, it is important to note that a "debt-claim" may also arise from a loan for use (*comodatum*), for South African legal purposes too – however this may not typically involve money.

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<sup>147</sup> The term "debt-claim" is not defined in the OECD Model (2014).

In order to qualify as interest income for the purposes of article 11, the income should be from a “debt-claim”. It follows that interest is generally taken to mean remuneration on money lent<sup>148</sup>, in other words, it is the payment for a transfer of the use of debt capital<sup>149</sup>, i.e. the remuneration received for making debt capital available.<sup>150</sup> If there is no debt-claim, there cannot be interest under the meaning of article 11. It follows therefore that a payment on a debt-claim, which is determined according to the functions of time, the rate of return and the amount of the principal is interest, regardless of what the payment is called or when it is made. Any income from a debt-claim qualifies, provided that the item concerned is not specifically excluded from the scope of the definition of interest.

The phrase “income from debt-claims” forms the core of the definition of interest.<sup>151</sup> Interest is “income from debt-claims of any kind”.<sup>152</sup> The term “debt-claim” is not defined. Despite this lack of clarity, it is clear from the wording of article 11(3) to the effect that the term “debt-claim” has an extensive meaning.<sup>153</sup> Income covered by article 11 does not have to be income from securities; income from any kind of debt-claim qualifies.<sup>154</sup> The definition obviously covers cash deposits and security in the form of money, as well as government securities and bonds and debentures. Because of their prominence, the latter three are specifically noted as examples in the interest

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<sup>148</sup> Para. 1 OECD Model: Commentary on Article 11 (2014).

<sup>149</sup> See IBFD Glossary where a method of financing a business is by funding through debt capital, i.e. funds obtained through various types of loans. Debt capital normally comprehends debentures and bonds bearing fixed interest. There are, however, hybrid forms of capital, such as bonds that are convertible into shares (i.e. a convertible bond), bonds bearing interest at rates that depend on the profitability of the company (participating bonds), etc. Also it can be noted that economic double taxation may be the consequence in these situations. See K. Vogel, *Klaus Vogel on Double Taxation Conventions* 3rd ed., pg. 713 (Kluwer 1997).

<sup>150</sup> Id. at pg. 731.

<sup>151</sup> It should be noted that the tax treaties of some Islamic countries in the Middle East do not use the term “interest” at all but instead use only the phrase “income from debt claims” in their tax treaties. See H. Pijl, *The Concept of Interest in Tax Treaties, in Tax Treatment of Interest for Corporations* (O. Marres & D. Weber eds., IBFD 2012), Online Books IBFD, who points to the Bahr.-Neth. Income Tax Treaty (2008) and the Neth.-Saudi Arabia Income Tax Treaty (2008).

<sup>152</sup> In the view of Pijl, it would be sufficient to define interest as “income from debt-claims” and to stop there; the term “interest” would be unnecessary. See Pijl, *Interest from Hybrid Debts in Tax Treaties*, 65 Bull Int. Taxn. 9, sec. 3. (2011), Journals IBFD. This might leave questions, however, regarding gain in excess of accrued unpaid interest on a sale of a debt instrument.

<sup>153</sup> Vogel, *Klaus Vogel on Double Taxation Conventions* 3rd ed, (Kluwer 1997), at pg. 732, notes that the term “debt-claim” should be understood in its broadest sense.

<sup>154</sup> India has interesting case law concerning the treaty classification of interest paid on a tax refund. According to Indian case law, interest on a tax refund falls within the interest article of tax treaties.

definition in article 11(3). Another reason for the express mentioning is the fact that they may also present certain peculiarities.<sup>155</sup>

Therefore, the lack of a (legal) debt-claim may inadvertently preclude income from ‘non-traditional’ financial arrangements from the scope of article 11. This exclusion ostensibly also relates to Islamic financial instruments. As previously discussed, under domestic laws, the murabahah are assimilated to debt relations, although their legal form is not a loan under contract law. Despite this, as can be seen from a South African legal perspective, a “debt-claim” can ostensibly be created under both a loan for use and a loan for consumption as it broadly relates to obligations required to be undertaken. However it is only once the loan involves money and there is an associated charge in respect of the loan that the “debt-claim” under article 11 is triggered. On face value this therefore may create uncertainty at a cross-border level.

The Commentary on article 11 of the UN Model (2011) specifically considers that the interest article may apply to payments made under Islamic Finance arrangements.<sup>156</sup> Even though the legal form is not a debt-claim, the economic reality of the contract underlying the instrument may be seen as a debt-claim.<sup>157</sup> Whilst the OECD Commentary posits that even if a country does not specifically deal with non-traditional finance arrangements under its domestic tax law, it may apply the interest article if it uses an economic-substance-based approach for tax purposes.<sup>158</sup>

It is clear that, absent a specific mention of Islamic financial instruments in a tax treaty, uncertainty may result as classification conflicts are likely to arise. Particularly as a “debt-claim” is an undefined treaty term that must be interpreted in accordance with article 3(2). The term would be given the meaning that it has under the domestic tax law of the state applying the tax treaty, unless the context otherwise requires. It is not inconceivable that the two states applying the tax treaty may give different meanings to the term “debt-claim” or indeed may perhaps have established an Islamic finance

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<sup>155</sup> Para. 18 OECD Model: Commentary on Article 11 (2014).

<sup>156</sup> Para. 19.1 UN Model: Commentary on Article 11 (2011).

<sup>157</sup> Id. Refers to: murabahah, istisna’a, certain forms of mudarabah and musharakah, i.e. profit-sharing deposits and diminishing musharakah, and ijarah, where assimilated to finance lease, as well as sukuk based on such instruments.

<sup>158</sup> Para. 19.3 OECD Model: Commentary on Article 11 (2014).

regime at a domestic level and, therefore, apply different articles on the income paid under an Islamic financial arrangement. There is no guarantee that the UN Model (2011)'s interpretative recommendation will be followed in any given state.<sup>159</sup> In essence, these new paragraphs encourage states to follow an economic approach, instead of a legal approach.

In estimating the chances of success of these paragraphs, it must be considered that the respective positions of the UN Commentary and indeed the OECD Commentary are particularly low as there remains no legal obligation to follow either model only political goodwill by the respective parties.

It appears that a “debt-claim” under article 11's limited scope, does not include an arrangement that is not a legal debt-claim despite its economic substance. However, particularly with reference to article 32 of the Vienna Convention of the Law of Treaties (1969), the ordinary meaning may be overridden by other supplementary interpretational elements. This becomes even more important when considering the explicit intention of Islamic investors with regards to Islamic law. Consequently, even if complex multi-layered Islamic finance arrangements such as a murabahah may have considerable debt characteristics, it cannot fall within the ambit of article. It may be that these arrangements are intended to copy the time value of money in different contracts other than lending contracts, but, legally, remain what they are, i.e. deferred sales arrangements. Accordingly under a strict literal approach, a murabahah cannot be included under the permissive broadness of the interest definition's term “debt-claims of every kind”, even if the Islamic finance arrangement can, with regard to its terms, substantially be regarded as a debt-claim. However an approach that follows the ‘spirit of the law’ may be more accommodating to the extent the focus is on the underlying substance.

It would be prudent to point out that under the OECD Draft (1963), which catered for instruments that under domestic law were treated as interest in its final phrase (however deleted in 1977) “all other income assimilated to income from money lent by the

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<sup>159</sup> See *Pijl, Interest from Hybrid Debts in Tax Treaties*, at sec. 4.8 on how it is not self-evident that states will follow the UN recommendation concerning the Islamic instruments.

taxation law of the State in which the income arises”, this was theoretically possible, depending on the domestic law of the state in which the income arose.

#### 4.6 CONCLUSION

This chapter has analysed the position and history of the interest article from its inception in the OECD Model Tax Convention. In particular the evolution of the article through the input of various stakeholders and the consideration of article 11 in respect of historical practices involving cross-border debt funding. In essence, the issues that were raised were: can cross-border funding with no actual *legal* debt characteristics be entertained under article 11 and does a non-traditional debt finance claim fit into one of the categories of article 11(3)? It posited that the OECD Model (2017) asserts that in the absence of legal debt-claim characteristics, Islamic finance should not fall under article 11. This is due to the closed definition of interest contained therein.

The chapter also explained the specific historical development and structure of article 11(3) between the OECD Draft (1963) and OECD Model (1977) including the differences in the definitions of both and underlying justifications thereof. However, as discussed in those sections, the OECD Draft (1963) was in theory able to support the classification of Islamic finance arrangements due to the wording. This section also discussed the difficulties of the paragraphs in respect of Islamic finance arrangements included in the UN Model (2011) Commentaries on article 11 and the challenges faced despite their insertion.

Nonetheless, the core issue pertains to what the term “interest” includes for the purposes of article 11. As far as Islamic finance instruments such as a murabahah with considerable debt-claim characteristics are concerned, it is questionable as to whether it could qualify as a result of legal determination of a “debt-claim”. Accordingly, to the extent Islamic finance instruments such as the murabahah do not fall within article 11 (due to the lack of legal debt-claim and there is no reference to the domestic law of the country which may treat the income / expense as interest), it cannot be included under the interest definition’s term “debt-claims of every kind”. This is notwithstanding that the murabahah instrument can, with regard to its terms, substantially be regarded as a “debt-claim”. It follows therefore that the variations adopted by different states due to the reservations made (subsequent to the OECD Draft

(1963)) regarding article 11 coupled with the lack of uniformity between states whom have implemented domestic Islamic finance tax regimes, could likely establish a contemporary mismatch in the global tax treaty landscape concerning article 11. It is generally acknowledged that differences between domestic tax regimes or between the provisions of bilateral tax treaties are the essential ingredient for tax arbitrage.<sup>160</sup>

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<sup>160</sup> See P.J. Hattingh, *The Multilateral Instrument from a Legal Perspective: What May Be the Challenge?* 71 Bull. Intl. Taxn. 3/4 (2017), Bulletin for International Taxation IBFD, Sec. 5.2.2.

## CHAPTER FIVE

### ARTICLE 11 AND ARTICLE 10 IN THE CONTEXT OF ISLAMIC FINANCE

#### 5.1 INHERENT RELATIONSHIP BETWEEN INTEREST AND DIVIDENDS

As discussed in chapter four, the definition of interest in article 11(3) of the OECD Model (2017) includes all income from “debt-claims”. This definition is exclusive, with no reference to domestic law. In contrast, the definition of dividends in article 10(3) of the OECD Model (2017) includes, as one of a limb of three, “income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident”. It has been purported that traditionally, this limb of the definition of dividends was intended to cover interests in an entity not organised as a corporation but taxed as one.<sup>161</sup> It therefore follows that, where a contracting state’s domestic law classifies an instrument as equity, such income may be classified as dividends if both: (i) the income is considered from a corporate right at least under non-tax law; and (ii) the income is treated as a distribution from shares under the relevant domestic tax law.<sup>162</sup> There is, therefore, a potential overlap (in one direction), relevant especially to participating debt, hybrid debt and thin capitalisation cases.

The OECD’s Thin Capitalisation Report arose from the fact that, under the domestic laws of various countries, instruments labelled debt might be reclassified as equity based on thin capitalisation or other rules.<sup>163</sup> Consequently, the Commentaries on the OECD Model were amended to reflect the understanding that a contracting state may reclassify certain debt-claims as equity on, for example, a thin capitalisation basis. The theoretical basis set out in the report and in the OECD Commentaries was risk sharing,<sup>164</sup> which, however, does sit well with the standard of “other corporate rights”

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<sup>161</sup> See J.F. Avery Jones et al., *The Definition of Dividends and Interest in the OECD Model: Something Lost in Translation?* British Tax Review 4, p. 431 (2009).

<sup>162</sup> Id., at pg. 434.

<sup>163</sup> In some states, however, rather than reclassify debt instruments, deductions for amounts paid as interest thereon might be disallowed. In such cases, the treatment of the disallowed amount as interest for withholding and treaty purposes might or might not be disturbed.

<sup>164</sup> Para. 25 OECD Model: Commentary on Article 10 (2014) and paras. 19 and 22 OECD Model: Commentary on Article 11 (2014).

in the definition of dividends.<sup>165</sup> It is on this basis that tax treaties of many states have discarded the phrase “other corporate rights”.<sup>166</sup> On this basis it is interesting to note, considering that one of the key elements of the Islamic finance arrangement is in fact, risk sharing.

In light of this, the definition of interest in the OECD Model (2017) does not establish which article takes precedence if a payment seems to qualify both as interest and as a dividend. It may, therefore, be unclear as to which of the articles should be applied, i.e. article 10 or 11. The Commentary on Article 11 does, however, address the priority. The OECD Commentary on Article 11, suggests that the dividend article takes precedence over the interest article, despite not expressly referred to in the text of the respective articles.<sup>167</sup>

Many tax treaties differ from the OECD Model Tax Convention in taking a position on the priority between the dividend article and the interest article in the tax treaty itself. For instance, article 11(3) of the Nordic Convention (1996) specifically states that income from a debt-claim is interest, provided it is not a dividend covered by article 10(6). This formulation means that, if an item may qualify as both interest and a dividend, the item should be treated as a dividend. Many tax treaties also expressly provide that interest does not include any item which is treated as a dividend under the dividend article.<sup>168</sup> In general, Canadian and UK tax treaties and many US tax treaties, as well as the US Model Tax Convention, expressly provide that article 10 prevails in the event of an overlap.

Despite a specifically stated priority, it may not always be clear as to which article should be applied. A problem may arise, for example, if both the interest article and the dividend article make a reference to the treatment under domestic law while also

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<sup>165</sup> See J.F. Avery Jones et al., *The Definition of Dividends and Interest in the OECD Model: Something Lost in Translation?* British Tax Review 4, at pp. 447-448 (2009).

<sup>166</sup> *Id.*, at pp. 435-438.

<sup>167</sup> Para. 19 OECD Model: Commentary on Article 11 (2014). See also para. 42 OECD Model: Commentary on Article 11 (2014) for the reservations of Belgium, Canada, Estonia and Ireland regarding amending the definition of interest to secure that interest payments treated as distributions under their domestic law fall within the dividend article.

<sup>168</sup> See, for example, the P.R.C.-UK Income Tax Treaty art. 11(3) (2011); the Neth.-UK Income Tax Treaty art. 11(2) (2008); the Can.-Neth. Income Tax Treaty art. 11(5) (1986); the Australia-NZ Income Tax Treaty art. 11(5) (2009); the Ger.-Lux. Income and Capital Tax Treaty art. 11(2) (2012); and the Can.-US Income and Capital Tax Treaty art. 11(2) (1980). This approach is also followed in article 11(4) of the US Model (2016).

providing a priority rule that may not be the same as the domestic law priority rule. An example could be seen in an Australian case<sup>169</sup>, which concerned the interest article in the Australia-United States Income Tax Treaty (1982).<sup>170</sup> In this case, the Federal Court of Australia (“FCA”) gave specific priority to the dividend article. Both the dividend article and the interest article of the tax treaty, however, referred to the treatment under domestic law. Under domestic law, the distribution from a limited partnership was treated as a dividend for certain tax purposes, but as interest for domestic law withholding tax purposes. In this situation, the FCA gave priority to the interest article, despite the specific priority stated in the tax treaty.<sup>171</sup> This no doubt provides an illustration of the complexity in this area and that even within conventional finance arrangements only there ostensibly is also uncertainty created on a practical level.

## **5.2 PARTICIPATION IN PROFITS AND DEBT-CLAIMS (HYBRID DEBT)**

Where a debt-claim carries the right to participate in the debtor’s profits, does not prevent interest from falling under article 11. Article 11(3) specifically provides that it includes income from debt-claims that carry a right to participate in the debtor’s profit. According to the Commentary, participating bonds and debentures are regarded as loans for the purposes of article 11 “if the contract by its general character clearly evidences a loan at interest”.<sup>172</sup> Generally, income from a debt-claim is interest, whereas income from a corporate right is a dividend.

Even though article 11 defines interest autonomously as including all income from debt-claims without reference to domestic law, domestic law is, nevertheless, not without relevance. Domestic law may have relevance when classifying income from hybrid instruments, as the definition of dividends (unlike the interest article) under article 10 makes reference to domestic law<sup>173</sup> and because article 3(2) reverts to domestic law, unless the context otherwise requires. Therefore, to the extent that domestic law of countries caters for these circumstances, instruments that in form are

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<sup>169</sup> Deutsche Asia Pacific Finance Inc v Commissioner of Taxation [2008] FCA 837.

<sup>170</sup> Australia- United States Income Tax Treaty (1982).

<sup>171</sup> See J.F. Avery Jones et al., *The Definition of Dividends and Interest in the OECD Model: Something Lost in Translation?* British Tax Review 4, at pp. 448-449 (2009).

<sup>172</sup> Para. 18 OECD Model: Commentary on Article 11 (2014).

<sup>173</sup> The relevance of domestic law with regard to article 10 of the OECD Model (2014) is not, however, unlimited. Article 10(3) of the OECD Model (2014), which refers to domestic laws, in any case covers only income from corporate rights. The term “corporate right” may have to be given an autonomous treaty meaning instead of a domestic law meaning.

debt-claims may be re-characterised as equity or perhaps split with an equity component.

Based on the Commentary on article 11, interest on participating loans should not normally be considered as a dividend, unless the lender “effectively shares the risks” of the debtor company.<sup>174</sup> The same classification rule is applicable to interest on convertible bonds until such time as the bonds are actually converted into shares.<sup>175</sup> In addition to profit-participating loans, the test as to whether or not the lender effectively shares the risks of the debtor company is relevant in the case of other hybrid debts and thin capitalisation. Interest on a hybrid loan is intended to be reclassified as a dividend for the purposes of the OECD Model (2017) only if the lender effectively shares the risks of the debtor company.<sup>176</sup> It has been noted, however, there are practical issues in applying this standard.<sup>177</sup>

Therefore article 11, which on face value applies to income from all debt-claims without regard to their classification under domestic law, does not establish a hierarchy between itself and article 10. The Commentary on article 11, however, states that article 11 should not cover income which is treated as a dividend.<sup>178</sup>

The inclusion of profit-participating loans under the interest article raises difficult issues in relation to different types of debt-equity hybrids, the income from which may be either interest or dividend. For this reason, it is understandable that Canada, Chile and Norway have reserved the right to delete the reference to debt-claims carrying the right to participate in profits from the interest article.<sup>179</sup> Some states specifically exclude income from profit-participating debt-claims from the scope of the interest

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<sup>174</sup> Para. 19 OECD Model: Commentary on Article 11 (2014).

<sup>175</sup> Id.

<sup>176</sup> See para. 25 OECD Model: Commentary on Article 11 (2014). See also the GTTC Chapter on Article 10 for the items that qualify as dividend for treaty purposes and M. Helminen, *The Dividend Concept in International Tax Law* pp. 270-274, 291-296 and 336-339 (Kluwer 1999); and S.-E. Bärsch, *The Definitions of Dividend and Interest Contained in the OECD Model, Actual Tax Treaties, and the German Model*, 42 *Intertax* 6/7, at pg. 437 (2014), for the issue of when the lender is considered to share the risks of the debtor company.

<sup>177</sup> See J.F. Avery Jones et al., *The Definition of Dividends and Interest in the OECD Model: Something Lost in Translation?*, *British Tax Review* 4, p. 447 (2009).

<sup>178</sup> Para. 19 OECD Model: Commentary on Article 11 (2014).

<sup>179</sup> Para. 43 OECD Model: Commentary on Article 11 (2014).

article of their tax treaties.<sup>180</sup> Other tax treaties, such as the Netherlands-United States Income Tax Treaty (1992),<sup>181</sup> instead specifically state that the dividend article covers income from debt-claims carrying the right to participate in profits. It is evidenced above, that there is substantial subjectivity with regards to the positions adopted by various countries. As such many tax treaties further differ from the OECD Model (2017) in that part of their dividend article that refers to domestic law does not require that the income treated as dividend is from corporate rights.<sup>182</sup> The scope of the dividend article of such tax treaties may be broader with regard to income from hybrids than the scope of the dividend article of the OECD Model (2017).

This chapter enabled a comparison to be made with respect to the dividend article of the OECD Model (2017). It has discussed the approach taken with respect to the definition of a dividend within article 10(3) specifically. This juxtaposition illustrates a significant perspective as to perhaps why many of Islamic finance arrangements may encounter difficulties under article 11. The reason being that an arrangement has to be a debt-claim legally at first instance. However, as discussed, a substantial interpretation of what is legally not a debt-claim cannot make the arrangement a debt-claim for treaty purposes. Critically though the foregoing is ominously in contrast to what applies to hybrid-debt the other way around: what legally constitutes a debt-claim can, under a substance approach, be denied tax treaty treatment as a debt-claim.

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<sup>180</sup> For instance, the treaty policy of the Netherlands includes considering income from profit-sharing debt-claims to fall under the dividend article instead of the interest article. See the Netherlands Model (1987) and, for example, the Fin.-Neth. Income Tax Treaty art. 11 (1995) according to which the interest article does not cover debt-claims carrying a right to participate in the debtors' profits.

<sup>181</sup> Neth.-US Income Tax Treaty (1992).

<sup>182</sup> See also M. Helminen, *The International Tax Law Concept of Dividend* at ch. 9.2.4.1. (Kluwer 2010).

## **CHAPTER SIX**

### **CONCLUSIONS AND RECOMMENDATIONS**

The purpose of this dissertation was to analyse Islamic finance in the context of the OECD Model (2017). The analysis focussed on the Islamic finance regime and in particular the murabahah instrument. The discussion began by appreciating the context in which the Islamic finance industry has grown as an alternative to conventional financing principally due to excess wealth stemming from natural resources. It follows that there has been an increasing number of cross-border investments made by investors, especially from the Middle East, seeking profitable returns that are compliant with Islamic law. Furthermore, the financial crisis also enabled a debate regarding the sustainability of the conventional finance and banking industry.

The fact that Islamic finance principles to a large extent correspond with the principles of socially responsible investments, has also increased the general interest in Islamic finance. Essentially Islamic finance refers to the provision of financial services in accordance with Islamic law where it bans interest, products with excessive uncertainty, gambling, short sales, as well as financing of prohibited activities that it considers harmful to society. It also requires parties to honour principles of fair treatment and the sanctity of contracts where transactions must be underpinned by real economic activities, and there must also be a sharing of risks in those transactions.

Given these developments, countries were confronted with queries on how Islamic finance products should be treated within their tax framework particularly for the purpose of attracting foreign capital. In response, national governments from certain countries have endeavoured to issue guidelines or even amend their tax legislation in order to facilitate Islamic finance transactions. Whilst other countries accommodate Islamic finance within their existing tax framework, sometimes combined with the release of advance tax rulings and/or circulars providing general guidance. Nonetheless, under both approaches, it is generally intended that Islamic finance arrangements should be tax neutral.

Activities of Islamic financial institutions differ from those of conventional financial service providers in that charging interest on financial instruments is prohibited. Islamic financial products offered by Islamic financial institutions (or Islamic windows of conventional financial institutions, as the case may be) can take a wide variety of forms. This dissertation considered a commonly used product - the deferred credit sale (murabahah). The tax treatment of this transaction / instrument depends primarily on the (tax) classification of such instruments and the amounts paid (or received) thereunder. As a general rule, this classification can be based on a legal (or form based) approach or an economic approach. Under a legal approach, the instrument and the income therefrom is characterised according to the legal form of the contract, whereas under the economic approach, the economic substance of the transaction prevails.

The discussion was further expanded to describe the concept of “interest” in article 11(3) of the OECD Model (2017). The primary element of the interest definition was found to be income from “debt-claims”; however the rest of the definition stems from the historical origins of the definition as contained in post-World War One tax treaties entered into by Western European countries. It was also observed that the interest definition in article 11(3) of the OECD Draft (1963) was contrasted with that of the OECD Model (1977) and the key amendments explained with regards to the pivotal change in direction between the 1963 and the 1977 respective definitions. In 1977, the reasoning behind the OECD change was the perceived greater legal certainty and less external interference from individual states adopting unilateral measures which could thus influence the agreed balance of the allocated taxing rights.

Consequently it was observed that many of the arrangements in Islamic finance experience difficulties under tax treaties, the reason being that an arrangement has to be a debt-claim legally in the first place and that a substantial interpretation of what is legally not a debt-claim cannot make the arrangement a debt-claim for treaty purposes. It was also noted that the challenges faced by the paragraphs in the UN Model (2011) Commentaries on article 11. For completeness, the treatment of dividends (including the definition) and hybrid-debt in the OECD Model (2017) and its Commentaries was considered. It was found that after a substantial interpretation, what is legally a debt-claim can be treated as a dividend under the treaty for the purposes of article 10. This is over and above the consensus that the dividend article takes priority.

Furthermore, the International Monetary Fund has previously stated that “Islamic finance has the potential for further contributions. First, it promises to foster greater financial inclusion, especially of large underserved populations. Second, its emphasis on asset-backed financing and risk-sharing feature means that it could provide support for small and medium-sized businesses, as well as investment in public infrastructure. Finally, its prohibition of speculation suggest that Islamic finance may, in principle, pose less systemic risk than conventional finance”.<sup>183</sup> For this potential to be realised, however, and to allow the industry to develop in a safe and sound manner, a number of challenges will need to be addressed.

The awareness of the tax issues relating to cross-border Islamic finance transactions in has increased. As follows from this brief introduction, a level playing field has been created largely at a domestic level. However it is evident that the same objective has yet to be achieved on a cross-border level with uncertainty ensuing in terms of the practical application. Given the current developments and the increasing understanding and appreciation of Islamic finance in non-Muslim majority countries, the desired tax neutrality may well be gathering further momentum. In this regard, it is worth considering the viability of a possible return to the OECD Draft (1963) interest definition with its non-autonomous part.

This could perhaps demonstrate the initial appreciation of non-traditional financing the WP 11 may have inadvertently accepted during their original deliberations. This however would be disregarded subsequently in the superseded version of the OECD Model (1977).

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<sup>183</sup> International Monetary Fund Islamic Finance: Opportunities, Challenges, and Policy Options (April 2015).

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